IN THE COURT OF APPEAL (CIVIL DIVISION) **A2/2011/0070**

ON APPEAL FROM THE HIGH COURT OF JUSTICE (CHANCERY DIVISION, COMPANIES COURT) (MR JUSTICE BRIGGS)

IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE)

AND IN THE MATTER OF THE INSOLVENCY ACT 1986

WRITTEN SUBMISSIONS ON BEHALF OF THE INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION, INC. ("ISDA")

In these submissions, unless the contrary is stated: (a) references to Sections are to those of the 1992 ISDA Master Agreement (Multicurrency – Cross Border) and the ISDA 2002 Master Agreement (together, the 'Master Agreements'); and (b) capitalised terms refer to definitions used in those agreements. References to the appeal bundle are in the format [bundle/tab/page].

A. Introduction

1. This appeal, brought by the administrators of Lehman Brothers International (Europe) ('LBIE') (the 'Administrators') against the order of Briggs J dated 21 December 2010, concerns the effect of certain provisions in the standard form Master Agreements. The Master Agreements, which have been developed by ISDA over the last 25 years, serve as the contractual foundation for more than 90% of over-the-counter derivatives transactions globally.

2. The respondents to the appeal are counterparties who had entered into interest rate swap transactions (the 'LBIE Transactions') with LBIE, paying LBIE a fixed amount and receiving from LBIE an amount determined by reference to a floating rate of interest, thereby hedging the counterparties' risk in respect of increases in interest rates. Since 15 September 2008, when LBIE was placed in administration, each of the respondents, as a Non-defaulting Party, has relied on the condition precedent contained in the first limb of Section 2(a)(iii) of its Master Agreement to permit it, by reason of the continuing Events of Default caused by LBIE's insolvency, not to make payments to LBIE. Before the Judge, LBIE contended, for a series of reasons, that such reliance is not permitted.

3. While the decision of Mr Justice Briggs (and, therefore, this appeal from that decision) necessarily concerns the LBIE Transactions, given the very widespread use of the Master Agreement in financial markets worldwide, it potentially has far-reaching consequences for participants in the derivatives market more generally. In this context, the Court granted ISDA, which is described in more detail in Section B below, permission to intervene in the application by serving evidence (which it did through a witness statement of David Geen) and a position paper, and making oral and written submissions at trial.

4. ISDA now seeks the permission of the Court of Appeal to intervene in this appeal on the basis that (a) ISDA will be responsible for its own costs (so that it is not entitled to look to the parties in respect of its costs); and (b) the parties shall not be entitled to seek to recover their costs from ISDA so long as ISDA acts reasonably.

5. ISDA seeks that permission in order to make the written submissions set out below and, to the extent appropriate, to make brief oral submissions at the hearing of the appeal, in relation to the following two issues:

(1) Whether the Judge was correct to hold, in connection with the 1992 Master Agreement (see [66] to [74]), that where a Defaulting Party is subject to an Event of Default, or Potential Event of Default, at the date for performance of an obligation under Section 2(a)(i), Section 2(a)(iii) has the effect of "suspending" the coming into effect of the relevant obligation, so that upon the cure of the Event of Default, or Potential Event of Default, the obligation then arises. The Fourth Respondent ('KPGZ') appeals against that conclusion. ISDA (in agreement with the Administrators) contends that the Judge was correct on this point. This issue is dealt with in Section C below.

(2) Whether the Judge was correct to hold (see [75] to [79]) that an obligation to make a payment or delivery under Section 2(a)(i), the coming into effect of which is "suspended" by Section 2(a)(iii), ceases to exist altogether at the end of what he called the "term of the Transaction". The Administrators have appealed against that conclusion (albeit only as an alternative to their principal argument that Section 2(a)(iii) suspends the coming into effect of an obligation for a "reasonable period" only[1]). ISDA, in agreement with the Administrators on their alternative argument, contends that the Judge was wrong on this point. This issue is dealt with in Section D below.

6. ISDA's position on these two issues is, in short, that absent any provision to the contrary in a particular Confirmation, the effect of the Master Agreement is that obligations to pay or deliver under Section 2(a)(i) are only discharged if performed or upon the occurrence or effective designation of an Early Termination Date (in which latter case they are replaced by an obligation to pay the amount determined under Section 6(e)). In particular, the Master Agreement does not have the effect that where, following an Event of Default,

[1] See paragraph 83 of the Administrators' Skeleton Argument.

a Non-defaulting Party chooses not to designate an Early Termination Date, its obligations to pay or deliver under Section 2(a)(i) are extinguished because the Event of Default exists on either (a) the date specified for performance of the obligation in question or (b) the last date specified for performance of a Transaction.

7. As to the balance of the issues on the appeal, ISDA's position is as follows[2]:

(1) As to the Administrators' argument that a term limiting the effect of Section 2(a)(iii) should be implied, the Judge was correct to hold that there was no basis upon which to imply any limitation on the effectiveness of the condition precedent in Section 2(a)(iii), so the Administrators' appeal in that respect should be dismissed.

(2) As to the anti-deprivation principle, the Judge was correct to hold that it was inapplicable to Section 2(a)(iii), so that the Administrators' appeal in that respect should also be dismissed.

8. By the time of the PTR on 8 October 2010, the Administrators and each of the Respondents consented to ISDA's participation, on the costs basis set out above.

9. ISDA has canvassed the reaction of the other parties to its application to intervene on this appeal. The Administrators have indicated their consent. The respondents do not oppose, nor consent to, ISDA's intervention[3].

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2 In relation to these issues, ISDA's position is set out in detail its Position Paper and Skeleton Argument before the Judge. In broad terms, it agrees with the position of the Respondents, which was adopted by the Judge. At this stage, therefore, ISDA does not anticipate making submissions in relation to those issues.

3 See Linklaters' letter dated 8 April 2011, and those of Macfarlanes dated 14 April 2011, Freshfields dated 12 April 2011 and Clifford Chance dated 24 June 2011.

B. ISDA, the Master Agreements and the derivatives market

10. ISDA, a Not-for-Profit Corporation incorporated in the State of New York, was formed in 1985, shortly after the emergence of a recognised swaps market. Its members are participants in the privately negotiated, or over-the-counter ("OTC"[4]), derivatives industry. It is among the largest global financial trade associations by number of member firms. It has over 820 member institutions, including most of the world's major institutions that deal in OTC derivatives, as well as many of the businesses, government entities and other end-users that rely on derivatives to manage the risks inherent in their core economic activities[5].

11. The derivatives market is now very substantial. At the end of 2009, for example, the notional amount of interest rate derivatives outstanding was $426.8 trillion, the notional amount of credit default swaps was $30.4 trillion and the notional amount of equity derivatives was $6.8 trillion.

12. Section 13 of the Master Agreements contemplates that a Master Agreement will be governed by and construed in accordance with, either English law or the laws of the State of New York[6]. Many derivative contracts are governed by English law and are subject to the jurisdiction of the English Courts.

The 1992 and 2002 Master Agreements

13. ISDA's primary purpose is to encourage the prudent and efficient development of the privately negotiated derivatives business[7]. In furtherance of that purpose, and recognising that the speedy and effective documentation

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4 As opposed to exchange-traded derivatives.

5 Geen w/s, para 5 to 6.

6 Section 13 of the Master Agreement and Part 4 (e) of the Schedule. The English Court will have jurisdiction if English law is selected.

7 Geen w/s, para 7.

of derivatives transactions is critical[8], ISDA has developed standard contractual wording and documentation architecture for market participants, first in relation to swaps and then, since 1992, in relation to OTC derivatives more generally, in order to minimise the cost and delay involved in drafting and negotiating agreements.

14. In particular:

(1) In 1985, and in a revised version in 1986, ISDA published a Code of Standard Wording, Assumptions and Provisions for Swaps, which comprised a set of standard definitions and terms that could be incorporated in whole or in part into separate agreements for individually negotiated swap transactions.

(2) In 1986, ISDA commenced the development of a single form of master agreement that could be used to document the overall relationship between parties that wished to enter into transactions from time to time. This resulted in the 1987 ISDA Interest Rate and Currency Exchange Agreement.

(3) The concept was expanded in the 1992 Master Agreement, under which parties could enter into any form of OTC derivative transaction, not merely swaps, including physically settled transactions. The 1992 Master Agreement included modifications and clarifications based on the experience of ISDA's membership since 1987.

(4) The 2002 Master Agreement followed a decade later, though many transactions globally continue to be governed by the 1992 Master Agreement. The product of a strategic document review, the 2002

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8 See: Firth, Derivatives, Law and Practice, para 10-001; Wood, Set-off and Netting, Derivatives, Clearing Systems, para 12-002 to 12-004.

Master Agreement contained adjustments based on lessons learnt since 1992, especially following periods of market turmoil in the late 1990s.[9]

15. The conditions precedent contained in Section 2(a)(iii), together with the mechanism dealing with the designation of Early Termination Dates and the close-out methodology, have been a part of the evolving standard form since 1985[10]. While other provisions of the Master Agreement have been altered, this term has remained substantially the same.

16. Each of the Master Agreements is the subject of a User's Guide published by ISDA, which explains, for example, the architecture of the documentation, and how it is contemplated that the process of documenting transactions will take place.

17. The standard documentation is designed to be used to document many different categories of OTC derivatives transactions such as interest rate swaps, currency swaps, credit default swaps, commodity swaps, equity swaps, caps, collars and floors, currency options, foreign exchange transactions and options of various types.

18. The Master Agreement constitutes a framework of standard terms which parties are free to adopt in whole or in part, and subject to such amendments as they wish. The first part of the agreement is a pre-printed form; amendments and elections are set out in the Schedule to the Master Agreement. Confirmations set out the particular terms of individual transactions entered into under the Master Agreement. Confirmations for different categories of

9 See the Introduction to the User's Guide to the 2002 Master Agreement. See generally, Geen w/s, paras 8 to 12 and Firth, Derivatives Law and Practice, at para 10-001 to 10-005.

10 See Sections 10.2 and 11 of the Code of Standard Wording (1985 edition). By the time of the Interest Rate and Currency Exchange Agreement, in 1987, the condition precedent was contained in Section 2(a)(iii) and Section 6 dealt with Early Termination.

transaction incorporate sets of standard provisions and definitions specific to these transaction types from booklets of definitions published by ISDA[11].

Close-out netting under the Master Agreements

19. Close-out netting under Section 6 is an important part of the Master Agreements, aimed at mitigating the risks associated with over-the-counter derivatives, for the benefit of both parties[12]. It refers to the process by which, on the occurrence of an Early Termination Date following an Event of Default, unperformed obligations are cancelled, and positive and negative replacement values across all Transactions governed by a Master Agreement are combined into a single net payment or receivable[13]. The result of close-out netting is to reduce both parties' credit exposure from the other's default from gross exposure to net exposure. As such, it is of great importance: the "single most important technique for reducing credit risk in the OTC derivatives market is contractual termination and close-out netting"[14]. According to the Bank for International Settlements, netting benefit, measured as the difference between gross mark-to-market value and credit exposure after netting, was about 84 per cent as at the second half of 2009[15]. The importance of close-out netting is acknowledged by public authorities with oversight of the financial

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11 For example, Credit Derivatives Definitions, Commodity Derivative Definitions: see Appendix A to the User's Guide to the 1992 Master Agreement.

12 Close-out netting is to be distinguished from payment (or settlement) netting under Section 2(c) of the Master Agreement. Payment netting involves combining offsetting cash flow obligations between two parties on a given day in a given currency into a single net payable or receivable.

13 Annetts and Murray, 'Set-off, Netting and Alternatives to Security' in Prentice and Reisberg (eds), Corporate Finance Law in the UK and EU (2011), p. 269.

14 Henderson on Derivatives (2nd ed), para 11.1.

15 The BIS figures are set out in Henderson on Derivatives (2nd ed), para 11.1. See also, Wood, Set-off and Netting, Derivatives, Clearing Systems (2nd ed, 2007), para 1-012.

markets at international, European and national level and the strengthening of the legal framework for close-out netting is the subject of law reform projects at the European and international levels.[16]

20. In order for close-out netting to function as a means of reducing credit exposure for both parties, it is important that a liquidator (or other insolvency office-holder) cannot cherry-pick profitable Transactions, while at the same time the Non-defaulting Party receives only a dividend in relation to those transactions where the Defaulting Party is "out of the money"[17].

21. Close-out netting is achieved through a series of provisions of the Master Agreements. For example:

(1) The introductory recital to the Master Agreements provides the mechanism by which a series of Transactions may be entered into under a single Master Agreement. It indicates that the parties:

> *"have entered and/or anticipate entering into one or more transactions (each a "Transaction") that are or will be governed by this Master Agreement, which includes the schedule (the "Schedule"), and the documents and other confirming evidence (each a "Confirmation") exchanged between the parties confirming those Transactions."*

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16 See, for example: Basel Committee on Banking Supervision, Report and Recommendation of the Cross-Border Bank Resolution Group (March 2010), part 8; HM Treasury, Special resolution regime: safeguards for partial property transfers (November 2008), paras 1.26-1.32 and chapter 2; Paech, 'Systemic risk, regulatory powers and insolvency law – the need for an international private law framework for netting', University of Frankfurt Institute for Law and Finance Working Paper, Series No. 116 (March 2010), esp. pp.6-16; Institute for the Unification of Private Law (UNIDROIT), Preliminary draft report on the need for an international instrument on the enforceability of close-out netting in general and in the context of bank resolution, UNIDROIT 2011 Study 78C – Doc. 2 (March 2011), esp. pp. 29-32.

17 See Wood, Set-off and Netting, Derivatives, Clearing Systems (2nd ed, 2007), para 1-031 and 12-010; Firth, Derivatives Law and Practice, para 5-005.

(2) Section 1(c) makes plain that the Transactions cannot be regarded in isolation but are agreed to form a single agreement:

> *"**Single Agreement.** All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as this 'Agreement'), and the parties would not otherwise enter into any Transactions."*

(3) Where an Early Termination Date is designated or occurs following an Event of Default, <u>all</u> outstanding Transactions are affected, so that no further payments or deliveries will be required to be made under Section 2(a)(i) or 2(e) in respect of any of them: Section 6(a) and Section 6(c)(ii). Instead, any amount due shall be determined pursuant to Section 6(e)(i).

(4) Under Section 6(e)(i), the values of "*all Transactions ... in effect immediately before the effectiveness of the notice designating that Early Termination Date*" are taken into account in determining either the Market Quotation or the Non-defaulting Party's Loss (which are described further below)[18].

<u>Events of Default</u>

22. Section 5(a) sets out a series of Events of Default, including Failure to Pay or Deliver (Section 5(a)(i)) and Bankruptcy (Section 5(a)(vii)). Section 6(a) provides that once an Event of Default has occurred and for so long as it is continuing, then the party that is not subject to the Event of Default (the Non-defaulting Party) may, by notice to the other party (the Defaulting Party), designate a day as an Early Termination Date in respect of all outstanding

[18] See the definition of Terminated Transactions in Section 14.

Transactions[19]. As noted above, Section 6(c) provides that on effective designation of an Early Termination Date no further payments or deliveries under Section 2(a)(i) are required to be made by either party. A final net termination payment will instead be made in accordance with Section 6(e).

23. Alternatively, following the occurrence of an Event of Default, the Non-defaulting Party may choose not to serve a notice designating an Early Termination Date, thereby leaving both parties' obligations under Section 2(a)(i) to subsist, albeit "*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*"; that is, Section 2(a)(iii).

24. Thus, on the occurrence of an Event of Default or Potential Event of Default and for so long as it is continuing, the Non-defaulting Party has a choice: it may terminate all outstanding Transactions (in which case the termination sum is calculated and becomes due), or it may allow them to subsist, with the benefit of the protection provided by Section 2(a)(iii)[20] (as to which see paragraph 41 below).

Payment on an Early Termination Date: First Method and Second Method

25. Following an Event of Default, the Non-defaulting Party may designate an Early Termination Date[21]: Section 6(a).

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19 This, and the next two paragraphs, assume that Automatic Early Termination has not been specified in the Schedule as applying to the Defaulting Party, or that if it has been specified that the Event of Default in question is not one of those identified in Section 6(a).

20 Where there is no Event of Default, but only a Potential Event of Default (that is, according to Section 13, "*any event which, with the giving of notice or the lapse of time or both, would constitute an Event of Default*"), then there is no right to designate an Early Termination Date, but Section 2(a)(iii) is engaged.

21 This assumes that Automatic Early Termination has not been designated by the parties in the Schedule to the Master Agreement.

26. Under the 1992 Master Agreement, the parties may elect, in the Schedule, both a payment measure ("*Market Quotation*" or "*Loss*") and a payment method ("*First Method*" or "*Second Method*"). If no election is made, "*Market Quotation*" and "*Second Method*" apply: Section 6(e).

27. Each payment measure, whether "*Market Quotation*" or "*Loss*", explicitly requires those amounts that would have been paid to the Defaulting Party but for the application of Section 2(a)(iii) to be included in the termination calculation.

28. Specifically, where "*Market Quotation*" is the payment measure, Section 6(e)(i)(3) requires a calculation that takes into account "*Unpaid Amounts owing to the Defaulting Party*". "*Unpaid Amounts*" owing to any party is defined in Section 14 to include, with respect to an Early Termination Date, not only amounts that became payable and remain unpaid but also amounts that would have become payable but for Section 2(a)(iii) (or, with respect to delivery obligations, the fair market value of that which would have been required to be delivered but for Section 2(a)(iii)). In addition, interest is to be added to such amounts from the date on which payment or delivery would have been made but for Section 2(a)(iii).

29. Similarly, where "Loss" is the selected payment measure, Section 6(e)(i)(4) provides that "*an amount will be payable equal to the Non-defaulting Party's Loss*". "Loss" is defined in Section 14 to include:

> *"losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made".*

30. The 1992 Master Agreement provides a mechanism for calculating the mark-to-market value of each transaction under it that has been terminated, and for netting such amounts, together with Unpaid Amounts, to reach a single net sum.

31. This mechanism applies regardless of whether First Method or Second Method has been selected. Under the First Method, however, it is only if the calculation results in a payment due by the Defaulting Party that payment is required to be made. In other words, under the First Method, the Defaulting Party is never entitled to any payment from the Non-Defaulting Party. By contrast, under the Second Method, payment is required to be made whether it is due from the Defaulting Party or from the Non-defaulting Party. Under the 2002 Master Agreement, the First Method has been removed, leaving the Second Method as the sole payment method[22].

32. Accordingly, it is a fundamental part of the architecture of the 1992 Master Agreement, where the parties have adopted the Second Method, and of the 2002 Master Agreement, that upon the occurrence of an Early Termination Date, the net settlement amount determined as owing by either party to the other, taking account of all transactions governed by the Master Agreement, will be payable whether or not the net paying party is in default. In other words, the Non-defaulting Party may be required to make payment notwithstanding that it has not breached any obligation.

C. A Non-defaulting Party's obligation is not extinguished by an Event of Default continuing on the date specified for performance of that obligation

33. KPGZ appeals against the Judge's finding that Section 2(a)(iii) has the effect of preventing a payment or delivery obligation from arising for so long as an Event of Default or Potential Event of Default, which existed at the due date for performance of the obligation, is continuing but does not prevent that

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22 Section II.G.5 of The User's Guide to the 2002 ISDA Master Agreement explains that: "*The First Method has been deleted from the 2002 Agreement leaving Second Method as the sole payment method, in response to member comments that First Method was no longer used, most likely due to rules adopted by bank regulators that conditioned the recognition of netting for capital purposes on use of the Second Method.*"

obligation from arising once the Event of Default or Potential Event of Default is cured. KPGZ contends that if, upon the due date for performance of any obligation under Section 2(a)(i) of the 1992 Master Agreement, the party to whom performance is due is subject to an Event of Default or a Potential Event of Default, then not only does the relevant obligation not then arise, because of the operation of Section 2(a)(iii), but it can never arise thereafter, even if the Event of Default or Potential Event of Default is cured. In other words, according to KPGZ, Section 2(a)(iii) of the 1992 Master Agreement extinguishes any obligation that would otherwise accrue where the party entitled to performance of that obligation is suffering from an Event of Default or Potential Event of Default on the date specified for performance[23].

34. It was common ground before the Judge that this argument cannot apply to the 2002 Master Agreement, notwithstanding that the terms of Section 2(a) are materially the same in both versions of the Master Agreement, because the 2002 Master Agreement contains other provisions which expressly contemplate the survival of obligations which have not arisen at the date specified for performance as a result of Section 2(a)(iii): see, in particular, Section 9(h)(i)(3)(A) of the 2002 Master Agreement, which provides for interest to accrue on amounts that would have been paid but for Section 2(a)(iii) from the date on which such payments would (but for Section 2(a)(iii)) have been payable to the date on which they actually become payable.

35. ISDA contends that the conclusion reached by the Judge was correct. When the language used is analysed in the context of the 1992 Master Agreement as a whole, and in particular in light of the purpose of Section 2(a)(iii), then the "one time only" interpretation advanced by KPGZ is untenable.

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23 KPGZ adopts, in this respect, an *obiter dictum* of Flaux J in Marine Trade SA v Pioneer Freight Futures Co Ltd BVI [2010] 1 Lloyd's Rep 631.

Wording of Section 2(a)

36. Section 2(a)(i) requires each party to make each payment or delivery specified in each Confirmation. Section 2(a)(ii) stipulates that payments and deliveries under the Master Agreement shall be made on the due date specified in the relevant Confirmation.

37. The obligation to make payment or delivery under Section 2(a)(i) is subject, however, to the conditions precedent set out in Section 2(a)(iii). As noted above, the first of these is that "*no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing*."

38. As a matter of language, the words "*and is continuing*" can naturally and reasonably be construed as defining the time period during which the existence of an Event of Default or Potential Event of Default will have the effect that a particular payment or delivery obligation does not arise, i.e. that the obligation will not arise only for so long as the Event of Default or Potential Event of Default is continuing.

39. The Judge (although ultimately agreeing with this interpretation) considered that the language of Section 2(a) was more consistent with KPGZ's so-called "one time only" view of Section 2(a)(iii) [72]. ISDA respectfully disagrees. The words "*and is continuing*" make plain that Section 2(a)(iii) will not apply where an Event of Default or Potential Event of Default has occurred but by the date specified for performance has been cured. But it does not follow that if the Event of Default or Potential has not been cured by that date, the obligations are extinguished.

40. Nor does the remainder of the language of Section 2(a) point in favour of KPGZ's "one time only" interpretation. The fact that Section 2(a)(ii) requires payments and deliveries to be made on the due date specified in the relevant Confirmation does not carry with it any implication that if the obligation is not

satisfied on the due date for performance, then it ceases to exist. That would be a highly surprising result, and one which, especially given its draconian consequences, should not be reached without clear support in the language of the clause.

Purpose of Section 2(a)(iii)

41. Section 2(a)(iii) protects a Non-defaulting Party from the risk of making payment or delivery to a counterparty whose own ability to perform is in doubt (because it is either actually or potentially subject to an Event of Default, many of which are indicative of its inability to perform). In other words, its purpose is to protect a Non-defaulting Party from the additional credit risk of continuing to perform its own obligations *while the counterparty is in default or on the brink of default*.

42. It is not intended to enable the Non-defaulting Party permanently to escape from those of its obligations that would otherwise fall to be performed during the period of continuation of an Event of Default or Potential Event of Default affecting its counterparty. Thus, an obligation, which does not arise due to non-fulfilment of a condition precedent, is taken fully into account in the close-out calculation which occurs if all outstanding Transactions under the Master Agreement are terminated under Section 6[24]. In that case, the Master Agreement expressly requires that sums which would otherwise be due but for the operation of Section 2(a)(iii) be included in the close-out netting process.

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24 See Pioneer Freight Futures Company Limited (in liquidation) v TMT Asia Limited [2011] EWHC 778 (Comm) (per Gloster J) and Britannia Bulk plc v. Pioneer Navigation Ltd [2011] EWC 692 (Comm) (per Flaux J). In Pioneer Freight Futures Co v. Cosco Bulk Carrier Co [2011] EWHC 1692 (Comm), however, Flaux J held that the value of transactions which (in his language) had expired by “effluxion of time” prior to the Early Termination Date fell outside the close out netting provided for in Section 6. This conclusion is dealt with in Section D below.

43. This view of the commercial purpose of Section 2(a)(iii) was recently endorsed by Gloster J, in Pioneer Freight Futures Company Limited (in liquidation) v TMT Asia Limited, as follows[25]:

> "*it is obvious that the commercial function or purpose of the condition precedent to payment as set out in Section 2(a)(iii) is to mitigate counterparty credit risk during the currency of what may be numerous swap transactions under the umbrella of [the 1992 Master Agreement] and while they remain open. It ensures that a Non-defaulting Party does not have to pay a Defaulting Party, who may be of doubtful solvency, in circumstances where, under ongoing open swap transactions, a Defaulting Party may subsequently owe sums to the Non-defaulting Party.*"

44. Gloster J noted, at [72], that in order to achieve this credit protection purpose of Section 2(a)(iii):

> *"it is simply not necessary for the obligations of the Non-defaulting Party in respect of a Contract Month to be effectively extinguished once and for all or ... never to come into existence."*

45. While Gloster J was dealing with an argument that the obligation which was prevented from arising because of Section 2(a)(iii) was not to be taken into account in determining "Loss" on Automatic Early Termination, her reasoning applies equally to the argument that the obligation does not arise once the Event of Default or Potential Event of Default ceases to exist.

The Judge's conclusion

46. Briggs J reached his conclusion that the "one time only" interpretation was wrong (at [73] to [74]) for three reasons.

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25 [2011] EWHC 778 (Comm), at [69].

47. First, KPGZ's construction would produce a pointlessly draconian outcome in the event of a minor or momentary default. Events of Default cover a wide variety of circumstances, including a failure to pay or deliver on the due date for performance, or the failure to comply with any other obligation under the agreement, even if the breach is of limited duration or otherwise trivial[26]. It is difficult to envisage the commercial purpose in a provision which (on KPGZ's case) extinguishes the Non-Defaulting Party's own obligation to pay or deliver on a particular date merely because on that date (but not later) the counterparty was subject to an Event of Default. The Judge's conclusion in this respect is supported by the leading text book writers: see, for example, Firth, Derivatives: Law and Practice, paras 11-012 to 11-013[27].

48. Secondly, the outcome would be even more surprising in the case of a Potential Event of Default. The condition precedent in Section 2(a)(iii) is not met whenever the counterparty is subject to an Event of Default or a Potential Event of Default. As noted above, a Potential Event of Default is defined as any event which, with the giving of notice or the lapse of time or both, would constitute an Event of Default. On KPGZ's case, where the counterparty was subject only to a Potential Event of Default at the time that a payment obligation fell due, the paying party, while it would have no right to designate an Early Termination Date, would be relieved for all time from its obligation to pay, even in a situation in which the Potential Event of Default was cured during the grace period and thus never matured into an Event of Default. Thus, according to KPGZ, a party would be relieved of its obligation even though

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26 There are grace periods in relation to failures to pay or deliver (3 business days being standard under the 1992 Master Agreement) or breaches of other agreements or obligations, but that does not render KPGZ's approach commercially logical, since: (a) even during the grace period there would be a Potential Event of Default, so that Section 2(a)(iii) would be engaged; and (b) the all-or-nothing outcome would arise even if the grace period was exceeded by (say) a period of minutes.

27 This is a looseleaf reference work. The version before the Judge (the October 2010 release) discusses the obiter dictum of Flaux J in Marine Trade at paragraphs 11-012 to 11-013. The version cited to Flaux J in that case was presumably the text of the April 2009 release, under the same paragraph references.

the counterparty was ready, willing and able to perform, and did perform, within the grace period that had been agreed. This is a commercially absurd result.

49. Thirdly, it would be counterintuitive to find that an obligation that was to be taken into account in calculating the amount due to or from the Defaulting Party in the event of a termination under Section 6, following an Event of Default or Termination Event, ceased to exist by reason of Section 2(a)(iii) (see paragraph 42 above). The reference within "*Unpaid Amounts*" and "*Loss*" to sums that would have become payable but for Section 2(a)(iii), together with interest, makes it plain that the drafters of the Master Agreements did not intend that such payment obligations were to be extinguished. On the contrary, it contemplates that notwithstanding the occurrence of an Event of Default, the Non-defaulting Party continues to be under an obligation, which accrues interest, notwithstanding that it is not "*payable*" during that period. The inclusion of accrued interest is particularly telling.

50. ISDA contends that the Judge's conclusion and reasoning on this issue are correct.

51. The Judge's conclusion is also consistent (as the Judge noted) with the way in which the provision had been understood to work by Austin J in the Supreme Court of New South Wales in Enron Australia v. TXU Electricity [2005] NSWSC 1169[28], where he described Section 2(a)(iii) as having the effect that '…*a payment obligation will spring up under a pre-existing trade once the relevant condition is satisfied, and in that sense it might be said (with only approximate accuracy) that the payment obligation is "suspended" while the*

28 It is to be noted that: (a) the decision was primarily concerned with the scope of a liquidator's statutory power to disclaim a contract; and (b) it appears that this description was common ground between the parties. Austin J's decision was upheld by the New South Wales Court of Appeal [2005] NSWCA 12.

condition remains unfulfilled, and that amounts "accrue" notwithstanding that the condition is unfulfilled.'[29]

52. Since the decision of Briggs J, his conclusion has been preferred to that of Flaux J in Marine Trade by Gloster J in Pioneer Freight Futures v. TMT (above, at [94]), albeit *obiter*[30]. In Pioneer Freight Futures Co v. Cosco Bulk Carrier Co [2011] EWHC 1692 (Comm), at [85] to [88], Flaux J himself did not express any concluded view on the point, though (as set out below) he indicated that an argument identified by Cosco supported his analysis in Marine Trade.

KPGZ's arguments

53. At paragraph 30 of its skeleton, KPGZ makes four principal observations regarding Section 2(a), to support its contention that the "one time only" construction is the natural and obvious interpretation of the first limb of Section 2(a)(iii).

54. First, it relies on the fact that the payment obligations under Section 2(a)(i) are expressed to be time critical. A similar point is made at paragraph 34(a) of its skeleton, where it suggests that late or suspended performance may be of no use at all, and at paragraph 47(b), where it contends that the Judge failed to give sufficient weight to the time critical nature of a swap transaction. The fact that an obligation may be time critical, however, does not point towards that obligation ceasing to exist if it is not performed on the due date for performance. Time critical obligations are well known in the law, and typically have the important consequence that breach of them entitles the innocent party to terminate the contract. It is a non-sequitur to conclude from

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29 At paragraph 12 of the judgment of Austin J.

30 In TMT Asia Ltd v. Marine Trade SA [2011] EWHC 1329 (Comm), at [24], David Steel J declined to express a view on the issue in the context of a summary judgment application.

this, however, that breach of a time critical obligation relieves the innocent party from performing its own obligation, especially where that other party chooses to affirm the contract, rather than relying upon the breach to exercise a right of termination.

55. This argument also suggests a confusion between two different aspects of timing under a swap contract, the timing of calculation of the amount of obligations and the timing of payments. The amount of a party's obligations will necessarily be calculated on a date or dates identified in the relevant Confirmations. Thus, A's obligation to pay (for example) interest at a spread over LIBOR calculated on a particular day corresponds to B's obligation to pay (for example) interest at the contractually fixed rate, at specified points in time. But it does not follow that the mutual obligations to pay the sums so identified (or, in the case of a contract for differences, the single obligation to pay the net difference between the two matched sums) must cease to exist if not performed on that pre-determined date.

56. Often a counterparty to a swap transaction will be looking to the payments made to it under the swap to enable it to pay interest (or a particular currency obligation) on fixed dates under a contract with a third party, so that late performance under the swap contract will cause it prejudice. But it does not follow that if the counterparty fails to make payment on the due date under the swap contract, there is no benefit in late or suspended performance. The delayed, but continuing, obligation remains of value. A swap contract is no more time critical in this sense than any other contract where a party depends on performance by the counterparty in order to fulfil an independent obligation owed to a third party. It should also be noted in this regard that it is open to the Non-defaulting Party to specify an Early Termination Date and replace the swap transactions (and thus the cash-flows under them).

57. Secondly, KPGZ suggests that it is not merely performance of the obligation which is expressed as being dependent on the non-occurrence of an Event of

Default, but the existence of the obligation itself. This does not advance the analysis. Each Confirmation, from the moment of its execution, creates obligations. But no payment is required to be made (under Section 2(a)(i)) if unless the condition precedent in Section 2(a)(iii) is fulfilled. It makes no sense to distinguish between the obligation being conditional or its performance being conditional. A situation in which performance of the obligation has not become due, because of an unsatisfied condition precedent, can be described equally in terms of there being an obligation but no current requirement to perform it or there being no current obligation of which there could be performance, without any difference in economic or legal substance.

58. Thirdly, KPGZ suggests that the phrase "*and is continuing*" merely defines the circumstances in which the condition precedent will cease to operate. This is dealt with above.

59. Fourthly, KPGZ contends that the wording of Section 2(a) on its face does not leave scope for subsequent satisfaction of the condition precedent, because Section 2(a)(ii) requires that payments be made "*on the due date for value on that date*". For the reasons explained above, this point adds nothing.

60. At paragraph 32 of its skeleton, KPGZ echoes a point made by Flaux J in <u>Marine Trade</u>, based on the absence of any term in the Master Agreement which provides for the 'revival' of the obligation, performance of which is prevented by the non-fulfilment of the condition precedent. There is, however, no need for such a term. If Section 2(a)(iii) is construed as preventing the obligation to pay or deliver under Section 2(a)(i) from arising while an Event of Default or Potential Event of Default is continuing, then upon the Event of Default or Potential Event of Default ceasing to continue there is no longer anything to prevent the underlying obligation in Section 2(a)(i) from arising. That is the necessary consequence of the condition precedent remaining unfulfilled only for so long as the Event of Potential Event of Default is "continuing".

61. KPGZ seeks to rely (at paragraphs 34(c) and 35 of its skeleton) on the fact that as a matter of common law, a fundamental breach of an agreement relieves the innocent party from any further performance, so it is not surprising if Section 2(a)(iii) has that effect. This ignores, however, the following:

(1) At common law, the effect of the fundamental breach is not automatic, but requires the innocent party to accept it.

(2) Where innocent party does accept a repudiatory breach, it chooses to bring both parties' future performance of their primary obligations under the contract to an end[31]. But a party who chooses to rely on Section 2(a)(iii) rather than designating an Early Termination Date under Section 6, is making the opposite election: it is not terminating the contract, but electing to treat the contract as continuing.

(3) Parties to the 1992 Master Agreement, who adopt the Second Method, have deliberately chosen a regime applicable on an Early Termination Date which provides for the close-out of all Transactions governed by the Master Agreement, netting of amounts due each way under all Transactions, and the payment of a net sum either way, including (therefore) the possibility of payment of a net sum to the Defaulting Party.

In these circumstances, it would be illogical to conclude that Section 2(a)(iii) is intended to achieve for the Non-defaulting Party, who wishes to affirm the contract, practically the same result as would be achieved under the common law if there had been acceptance of a fundamental breach. Moreover, such a conclusion would achieve a more extreme result than would apply under First Method because it would relieve the Non-defaulting Party of paying the gross

[31] Chitty on Contract, para 24-02.

amount of its obligations rather than merely the net balance as would apply under First Method. This would undermine (and be inconsistent with) the election made by the parties for Second Method.

62. At paragraphs 41 to 43 of its skeleton, KPGZ argues that the Judge overstated the commercial absurdities flowing from the one time only construction. As to this:

(1) KPGZ relies on the specific terms of its Confirmation with LBIE to suggest that the examples of absurdities to be found in Firth would not apply to it (largely because of the six month gap between payment dates in its contract, minimising the risk of continuing default by the time of the next payment date).

(2) This ignores the fact that Section 2(a)(iii) is a provision of the Master Agreement that is intended to apply to a wide variety of Transactions, and intended to operate in relation to a wide variety of Events of Default and Potential Events of Default. It also ignores the possibility that other, equally trivial and short-lived, Events of Default or Potential Events of Default (e.g. breach of some other term of the Transaction) could entitle KPGZ to rely on Section 2(a)(iii), justifying the arguments based on the absurd results to which Firth points.

63. KPGZ attempts to avoid the difficulty created by the fact that Section 2(a)(iii) is equally triggered by a Potential Event of Default by arguing either (a) that this is simply one scenario for which the contract does not cater particularly well, and this is not enough to displace "the natural meaning of the express terms", or (b) that the definition of Potential Event of Default must be interpreted so as to be limited to something which does in fact evolve into an Event of Default (see paragraph 45 of its skeleton). Both arguments are flawed. Critically, there is nothing in Section 2(a)(iii) which suggests that

Potential Events of Default are to be treated any differently to Events of Default. Moreover:

(1) So far as the first point is concerned, KPGZ wrongly assumes that its reading of Section 2(a)(iii) is the only natural reading. This is wrong for the reasons set out at paragraphs 38 to 40 above. Where there is more than one way to read a provision, then that which leads to absurdities should normally be rejected. In any event, the inclusion of Potential Events of Default as a trigger for the non-fulfilment of the condition precedent in Section 2(a)(iii) cannot be dismissed as merely one (implicitly extreme) case for which the contract fails to cater properly.

(2) As to the second point, Section 2(a)(iii) is engaged at the point at which a Potential Event of Default occurs. It will be impossible to know, at that point in time, whether it is a Potential Event of Default which will subsequently mature into an Event of Default. However, in order that it may avoid potentially being in default itself, the Non-defaulting Party requires the certainty, while the relevant event remains a Potential Event of Default, of knowing whether it is required to perform any obligation that it may have under Section 2(a)(i) during that period.

64. Finally, KPGZ suggests (at para 47(c)) that the consequences of the Judge's construction are strange, because the Defaulting Party could wait, and subsequently decide to cure the Event of Default in the event that it was in its interest to do so. It is said that were the Non-defaulting Party to have entered into replacement swaps, then it would be at risk under both agreements.

65. The commercial consequences of the Judge's conclusion are not strange. Following an Event of Default, the Non-defaulting Party who is "out of the money" has a number of options, arising both out of its existing transaction

and the possibility of entering into a replacement swap. It may choose between them according to its own commercial judgement.

(1) The Non-defaulting Party may always choose to designate an Early Termination Date and, if it still wants the protection of a swap on the same economic terms, may enter into a replacement transaction with a third party. In that context, its overall position should not be altered as a result of the process of replacement. In general:

(a) Because under the terms of the replacement swap the replacement counterparty (which in effect steps into the shoes of the Defaulting Party) will be "in the money", the replacement counterparty will pay a premium to the Non-defaulting Party to step into LBIE's shoes, either (for example) by making an upfront cash payment or by providing its economic equivalent in the form of an enhanced rate under the swap.

(b) The amount of the premium will also determine the amount of the sum payable by the Non-defaulting Party to LBIE. This is the "gain" that it has received as a result of the cessation of its obligations under Section 2(a)(1).

By designating an Early Termination Date, the "out of the money" Non-defaulting Party can therefore obtain replacement protection at no (or no material) overall cost.

(2) Alternatively, the Non-defaulting Party may instead elect to keep the original transaction on foot over the long term, relying on Section 2(a)(iii) as meaning that payment obligations will not arise for so long as the Event of Default continues. It also may choose to enter a replacement swap. The consequence of it doing so is that it may retain

the benefit of the premium (or, as noted above, its economic equivalent in the form of a better rate under its replacement swap), without having to account to LBIE for an amount equal to that premium (or equivalent). Moreover, it can continue to do this *for so long as Section 2(a)(iii) applies*. It is true that it continues to run the risk that its obligations under Section 2(a)(i) could arise (since they have not been extinguished, and could arise if the Event of Default is cured, or if it becomes subject to an Event of Default itself), but this should not be viewed as unfair, or any form of *detriment* – it is merely the quid pro quo of it having opted to retain the value it achieved on entering into a replacement swap.

(3) Lastly, the Non-defaulting Party may delay making a decision as to whether or not to designate an Early Termination Date for a period, while it assesses and evaluates the position, relying in the meantime on the condition precedent in Section 2(a)(iii).

66. Any risk of the Non-defaulting Party being at risk under both transactions can be avoided by the Non-defaulting Party terminating the original swap. Similarly, there is no "one-way bet" (as alleged by KPGZ in para 47(c)); the extent to which the Defaulting Party is able to wait and see if the Event of Default is cured depends entirely upon the actions of the Non-defaulting Party in deciding whether or not to exercise its right to terminate.

67. There is one further point that needs to be dealt with in this context, concerning the effect of Section 2(a)(iii) in the context of physically settled obligations. In Pioneer Freight Futures v. Cosco Bulk (at [85] to [88]), Flaux J thought there was force in the submission that a delivery obligation should be automatically discharged in the event of non-compliance with the conditions precedent in Section 2(a)(iii) because otherwise the Non-defaulting Party could find itself, when any default was cured at a later date, having to make delivery of an asset which had increased in value since the original due date

for delivery meaning that the Non-defaulting Party was forced into a disadvantageous bargain by virtue of the very condition precedent which was inserted for its protection. As to this:

(1) There is no difference in principle between payment obligations, and physically settled delivery obligations. In either case, the Non-defaulting Party's decision to rely on Section 2(a)(iii) means that it may remain potentially exposed to future fluctuations in the value (for example) of currencies, interest rates or commodities.

(2) The answer in each case is that the Non-defaulting Party is not forced into that position. It can always choose to designate an Early Termination Date which would bring to an end all of its future payment or delivery obligations, and thus bring that exposure to an end. Thus if it considered that it would be commercially disadvantaged by being required to deliver late, the remedy would be in its own hands.

D. Non-defaulting Party's obligation not extinguished by Event of Default continuing on the last date specified for payment in a Transaction

68. If (as ISDA contends) the Judge was right to reject a construction of Section 2(a)(iii) having the effect that a Non-defaulting Party's payment obligations are automatically extinguished if there is an Event of Default or Potential Event of Default as at the date specified for performance in the Confirmation, the next issue is whether such obligations are automatically extinguished if there is an Event of Default or Potential Event of Default continuing on the last date for payment specified in the Confirmation.

69. The Judge concluded ([75] to [79]) that, as a matter of construction, any obligation of a Non-defaulting Party affected by Section 2(a)(iii) automatically ceases to exist altogether at the "expiry of the term" of the relevant LBIE

Transaction, that is "the last date for payment specified in the relevant Confirmation"[32], not because of the terms of the particular Confirmation in question, but as an unexpressed consequence of the provisions of the Master Agreement. To put it another way, if the Defaulting Party had not fulfilled the condition precedent in Section 2(a)(iii) by the last date for performance in the Confirmation, then it could never do so.

70. The Judge's conclusion on this issue has since been adopted and applied by Flaux J in Pioneer Freight Futures Co v. Cosco Bulk Carrier, at [50] to [67], where it was held (amongst other things) that a Non-defaulting Party's obligations under Section 2(a)(i), which were affected by Section 2(a)(iii) on the last monthly payment date specified under a freight futures agreement, automatically came to an end by "effluxion of time" on that last payment date. Flaux J took the Judge's conclusion a step further, holding that Transactions that had "expired" in this way as at the Early Termination Date were not to be taken into account in calculating the Early Termination Amount, i.e. were not included in the close-out netting process under Section 6: see [72] to [78].

71. ISDA, in agreement with the alternative case advanced by the Administrators at paragraph 83 of their skeleton, respectfully contends that the Judge's conclusion (and that of Flaux J) as to the meaning of the Master Agreement is wrong, unsupported by either its language or commercial considerations. Indeed, in so far as the Judge's conclusion is held to lead to that adopted by Flaux J, it may have serious consequences for the efficacy of close-out netting under Section 6, and thus for the reduction of exposure intended by those provisions of the Master Agreement and relied upon widely in the derivatives market.

[32] This is the phrase used by the Judge in [67].

72. The basis of the conclusion of each of Briggs J and Flaux J is the assumption that a Transaction can "terminate" by effluxion of time, and that such termination necessarily leads to the extinction of obligations under it: see the references to a "natural termination date" (in Flaux J's phrase at [34]) or termination by "effluxion of time" (in the Judge's phrase at [79]).

73. Indeed Flaux J considered this was the normal contractual analysis. For example, at [50] he said[33]:

> *"I agree with [Counsel for the Non-defaulting Party] that, as a matter of normal contractual analysis, if, at the time that a contract terminates at its natural expiry date (for example when the last date for performance passes), a condition precedent to one party's obligation remains unfulfilled by the other party, then, even if, immediately prior to termination, the other party could have fulfilled the condition precedent and brought the contingent obligation into existence, once the contract has come to an end, any such contingent obligation ceases to exist."*

74. Flaux J here makes an assumption that obligations under a contract automatically come to an end on the last date for performance. ISDA respectfully contends that this is wrong. As a matter of general principle, it is accurate to regard any contract as terminated when all obligations under it are fully performed. But the mere fact that, in relation to a contract which contains a series of dates for performance, the last date for performance has passed, does not mean that the contract has "terminated". Indeed, while there remain unperformed obligations under a contract (whether actual or contingent

[33] Flaux J summarised the Non-defaulting Party's submission at [37]: the "normal position under any contract is that, once it has terminated through natural expiry, the obligations under it also come to an end". See also at [58]: "However, as I have already said, in terms of normal contractual analysis, there is nothing in the slightest bit surprising about a conclusion that, if a contractual obligation is subject to a condition precedent and that condition precedent remains unfulfilled when the contract comes to an end, then the obligation does not revive after termination. I agree with [Counsel for the Non-defaulting Party] that if that somewhat heterodox effect were intended, one would expect the Master Agreement to say so in terms."

obligations) it is clearly inapposite to regard the contract as "terminated" in any sense which would lead to the extinction of outstanding obligations.

75. As noted in Section C above, it is possible for parties to contract out of that general principle, by agreeing that if a primary obligation is not performed on a specific date, because of a condition precedent affecting the counterparty, then the obligation will cease to exist altogether. The issue under consideration here, however, only arises if the Court accepts the Administrators' and ISDA's arguments on the one time only argument, i.e. if the Court rejects the notion that there was such a specific agreement here. In the absence of such agreement, it cannot be said that merely because an obligation does not arise on its due date for performance (because of a condition precedent affecting the other party) then the obligation ceases to exist. That must be as true, where a contract contains a series of obligations, for the obligation which is the last in time, as for each prior obligation. Accordingly, once the one time only argument is rejected in relation to each obligation which would fall due throughout the contract prior to the last one, there is no logical reason for reaching a different conclusion in relation to the obligation which would fall due for performance last in time.

76. ISDA contends that there is nothing in the Master Agreement which contradicts this approach. The terms are clear and unambiguous: the payment or delivery obligations of the Non-defaulting Party do not arise for so long as an Event of Default or Potential Event of Default continues, and there is no express end-date contained within the Master Agreement either for the obligation to be automatically extinguished or for the condition precedents to that obligation to fall away.

77. This approach is also commercially rational. As noted above, upon the occurrence of an Event of Default, a Non-defaulting Party may either keep the agreement alive, relying on Section 2(a)(iii) until such time as the Event of Default is cured, or designate an Early Termination Date. If the Non-

defaulting Party is "out of the money", so that it would have to make a payment if it chose to designate an Early Termination Date[34]:

(1) It may decide that its commercial interests are nonetheless best served by obtaining the certainty which is produced by opting for termination and (possibly) entering a replacement transaction, which overall should allow it to retain the same level of protection at no (or no material) additional cost.

(2) Alternatively, it may decide that the risk of the Event of Default ceasing is minimal, so that its commercial interests are best served not by obtaining the certainty arising out of the designation of an Early Termination Date, but by obtaining a replacement transaction and relying on Section 2(a)(iii), as having the effect that its obligations to LBIE will not arise. Because the Non-defaulting Party is "out of the money" as against LBIE under its original transaction, a replacement transaction will be "in the money" for the Non-defaulting Party, and it will receive a premium (or its economic equivalent in an enhanced rate under the replacement transaction) for entering into it. Thus, the Non-defaulting Party would have both the benefit of any protection that it required and that of not having to pay LBIE the amount it received under the replacement transaction.

78. The Administrators' evidence is that at the time LBIE entered administration about 2,000 of its Master Agreements had outstanding transactions under them (see [29] of the Judgment). Of those some 1,693 have since been closed out,

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[34] Similarly, if a Non-defaulting Party was concerned that an obligation to deliver securities, which was subject to Section 2(a)(iii) but might subsequently arise at a time by which the securities had increases in value (an example to which Flaux J referred in [59]-[60]), then it could choose to designate an Early Termination Date, and so escape that risk.

in many cases by designation of an Early Termination Date, and in some cases in circumstances which gave rise to payments to, rather than from, LBIE. In addition to the Respondents, only one LBIE counterparty has apparently indicated an intention to rely on Section 2(a)(iii) and no amounts would have been owed by that party to LBIE in any event[35].

79. The Judge's reasons for his decision on this issue (at [78] to [79]) were as follows:

(1) it was "wholly inconsistent with any reasonable understanding of the Master Agreement that payment obligations arising under a Transaction could give rise to indefinite contingent liabilities, because of the possibility that an Event of Default may be cured long after the expiry of a Transaction by effluxion of time";

(2) the general provision in Section 9(c) that obligations "survive the termination of any Transaction" is made subject to Section 2(a)(iii), which indicates that the liabilities made contingent by Section 2(a)(iii) are not to continue after the termination of any Transaction; and

(3) it is difficult to apply the "Early Termination" provisions after the natural expiry date of a Transaction.

<u>The Judge's first reason: unreasonableness of indefinite contingent obligations</u>

80. The first point is difficult to understand. There is nothing commercially abhorrent in the concept of an obligation remaining subject to a condition precedent for an indefinite period. As noted above, any supposed 'unfairness' to the Non-defaulting Party in its future payment obligations arising because

[35] See Linklaters' letter of 24 June 2010, prior to the hearing before the Judge.

the Event of Default is cured, is eliminated by the fact that the risk of such obligations arising is the result of the Non-defaulting Party's own choice to keep the transaction on foot rather than terminate it at no or no material additional cost it itself. Having made that choice, no doubt for the commercial reasons referred to above, it cannot reasonably complain of its consequences.

81. Moreover, this point appears to be based on the assumption that a Transaction terminates by the "*effluxion of time*", which is subject to the objections set out above. In addition, the identification of the last date for performance under a Transaction as the point at which the contingent obligation ceases to exist makes no commercial sense for the three reasons set out below.

82. First, as noted above, the consequence of the Judge's approach is that while Section 2(a)(iii) is of suspensory effect only in relation to every payment obligation in any Confirmation, save for the last, it will always have the effect of extinguishing entirely the Non-defaulting Party's last-in-time obligation under the Transaction.

83. It is important in this context to appreciate that a great variety of Transactions are effected pursuant to a Master Agreement including, in addition to plain swap transactions (such as those between LBIE and the Respondents in this case), transactions where the future payment or delivery obligations may be all one-way. The arbitrary effects of the Judge's conclusion are seen in sharp relief in the context of such transactions.

84. For example, a transaction might involve the transfer of initial value from A to B at the outset, with B being obliged to pay value to A upon certain contingencies (e.g. a derivative transaction where B is obliged to pay A the excess in price of a particular commodity over a certain fixed figure on future dates). On the day before the very last date for payment, a winding up petition is presented against A, but is dismissed or withdrawn within a period

of days. On the Judge's analysis, B would be relieved for ever from having to make that last payment[36]. There is no rational basis for that conclusion.

85. Another example is where a Confirmation specifies only a single date for payment or delivery (for example, an interest rate swap on a single particular date). The Judge rejected the "one time only" analysis, but his discharge by effluxion of time approach would cause precisely the same effect in such a Transaction, for no logical reason.

86. Secondly, if the Judge's conclusion were correct, then it ought to follow that amounts otherwise contingently due from B to A under a transaction in which the last date for performance of the primary obligations under it had passed could not be taken into account in the event that either party designated an Early Termination Date arising out of a breach in connection with another open transaction between them. In effect, therefore, it would require obligations under any transaction which had reached the end of its natural term to be excluded from the close-out calculation under Section 6. But this conclusion is not justified by the language of Section 6. It would, moreover, undermine the close-out netting provisions of the Master Agreement which are (as noted above) a feature of the Master Agreement which is of central importance to market participants world-wide in choosing to transact on its terms. So far as the language of Section 6 is concerned:

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36 A more extreme, but nonetheless entirely plausible, example would be if A transferred cash to B, by way of title transfer arrangement, to stand as economic security for contingent obligations owed by A under other derivative transactions with B under the Master Agreement. This is, in fact, a common arrangement, using the 1995 ISDA Credit Support Annex, which is annexed to the Schedule to the Master Agreement. Assuming that A is not indebted to B at the expiry of the term in relation to the other derivative transactions, B's only obligation is to repay the whole amount to A. A Potential Event of Default in relation to A the day before B's repayment obligation accrues would, on the Judge's analysis, relieve B of that obligation forever.

(1) The transactions which are required to be included in the netting process under Section 6(e), in the case of an Event of Default, are <u>all</u> Transactions "in effect immediately before the effectiveness of the notice designating that Early Termination Date".[37]

(2) If a category of Transactions was intended to be carved out, the scope of that category would be expressly spelt out. There is no such carve-out, however.

(3) The mere fact that, under a particular Transaction, the last date for performance has passed does not mean that the Transaction is no longer "in effect". It continues to contain legally binding contractual obligations.

87. That the logical extension of Briggs J's conclusion is that remaining contingent obligations under a transaction, where the last date for performance of primary obligations under it has passed, are not taken into account under the close-out netting provisions of Section 6 was indeed found to be the case by Flaux J in <u>Pioneer Freight Futures Co v Cosco Bulk Carrier</u>. ISDA respectfully submits that the conclusion reached by Flaux J in that case is wrong, for the same reasons that Briggs J was wrong. This conclusion, if correct, would seriously undermine the ability of parties to the Master Agreement to rely on the fact that close-out netting will apply across all Transactions they enter into under it, including Transactions that have passed the last date for performance but in relation to which 'Unpaid Amounts' (referred to in paragraph [28] above) are outstanding.

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[37] See Section 6(e), the definitions of "Market Quotation", "Loss" and "Terminated Transactions" under the Master Agreement.

88. Thirdly, the continuing existence of indefinite contingent liabilities creates a commercial incentive for a Non-defaulting Party to designate an Early Termination Date. It may choose not to do so for the reasons mentioned by the Judge in his decision, but this will be an additional factor weighed by the Non-defaulting Party in making that decision. Financial counterparties in particular may wish to close-out in order to obtain certainty as to their exposure, often for regulatory reasons. ISDA believes that this helps to explain why out of LBIE's 2,000 or so Master Agreement counterparties, it appears that only the Respondents and one other LBIE counterparty, as already noted, indicated an intention to rely on Section 2(a)(iii) rather than to close out.

<u>The Judge's second reason: the meaning of Section 9(c)</u>

89. The Judge's second point is based on an erroneous interpretation of Section 9(c) of the Master Agreement[38]:

> *"**Survival of Obligations**. Without prejudice to Sections 2(a)(iii) and 6(c)(ii), the obligations of the parties under this Agreement will survive the termination of any Transaction."*

90. ISDA submits that the meaning and purpose of Section 9(c) is as follows.

91. First, as to the clause after the comma in Section 9(c) ("*the obligations of the parties under this Agreement will survive the termination of any Transaction"*):

(1) The phrase "*this Agreement*" cross-refers to Section 1(c), set out above, which makes plain that all Transactions are part of a single

[38] It is common to include in a commercial contract a provision, similar to Section 9(c), expressly preserving the balance of the obligations in the event of the termination of the contract, or certain obligations under it. It is particularly common in termination and novation agreements of the type referred to in note 39 below.

agreement, under which numerous Transactions, each evidenced by its own Confirmation, might be entered into over an unlimited period.

(2) There is no provision anywhere in the Master Agreement for the termination of "*this Agreement*", as opposed to provisions dealing with termination in relation to Transactions.

(3) The clause makes clear, in this context, that if a particular Transaction entered into under the Master Agreement is terminated for any reason, then the balance of the parties' obligations under the single agreement nonetheless continue:

(a) If, as often happens, a particular Transaction is fully performed, or if the parties agree to unwind a Transaction before it is fully performed[39], so that the Transaction is discharged through performance or agreement, Section 9(c) means that the Agreement, including all other Transactions, continues in force nonetheless. Indeed, even if all Transactions come to an end, the Master Agreement stays in place in anticipation of future Transactions.[40]

(b) Where there is an Early Termination Date not involving an Event of Default, there may be Transactions under the

39 Termination of a Transaction by mutual agreement happens regularly in the market (including in the context of novation and in the context of off-setting arrangements known commercially as "tear-ups").

40 Section 4 contains agreements that continue for so long as either party has or may have any obligations under the Agreement. Often the Schedule to the Master Agreement will provide for ongoing "house-keeping", such as the provision of annual financial statements: see Section 4(a).

Agreement that are not terminated[41]. While, in relation to the Terminated Transactions, payments will be required under Section 6(c) and 9(h)(iii), in relation to other Transactions, the close-out mechanism in Section 6 will not apply, so that obligations will continue to be payable under Section 2.

Section 6(c) excludes any argument that the Agreement as a whole is brought to an end merely because a single Transaction comes to an end. Rather the single agreement survives.

92. Secondly, the clause before the comma in Section 9(c) ("*Without prejudice to Section 2(a)(iii) and 6(c)(ii)*") makes clear that, where an Early Termination Date has occurred, the continuation of the Agreement does not in any way qualify the close-out netting process by which executory payment or delivery obligations that would arise under Terminated Transactions are no longer required to be made and are replaced by a single obligation calculated under Section 6(e).

(1) The reference is to 2(a)(iii) *and* 6(c)(ii), i.e. to the two provisions together. They operate together as follows.

(2) Section 6(c)(ii) is the key provision for close-out netting because, wherever there has been an Early Termination Date, it requires any amounts payable to be determined under Section 6(e) (which produces a net sum payable either way across all Terminated Transactions).

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41 Where an Event of Default has occurred, an Early Termination Date always relates to all Transactions under the relevant Master Agreement. In relation to certain of the Termination Events (for example, Illegality, Force Majeure Event and Tax Event) where the Termination Event has occurred, the Early Termination Date may be designated in relation to less than all Transactions under the relevant Master Agreement (applying only to those affected by the relevant Termination Event, defined as "Affected Transactions" in Section 14 of the Master Agreement). In the latter case, therefore, one or more Transactions are terminated but other Transactions continue.

Section 6(c)(ii) achieves this, however, by bringing to an end the individual obligations to pay or deliver specified under Section 2(a)(i).

(3) Section 2(a)(iii), by its second limb, works in tandem with Section 6(c)(ii), because it provides that "*Each obligation of each party is subject to … the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated*". This has the effect, taken together with Section 6(c)(ii) of bringing to an end such obligations upon the occurrence of an Early Termination Date.

(4) The purpose of stating, in Section 9(c), that the survival of the Agreement is "*without prejudice to*" those provisions is to make plain that the obligations which survive under Section 9(c) do not include those which are brought to an end (and replaced with a different netting and payment obligation under Section 6(c)) in respect of Transactions that have been the subject of an Early Termination Date.

(5) The phrase reinforces the important function of preventing cherry-picking by a Defaulting Party, following an Early Termination Date. It prevents a liquidator, for example, from arguing that the survival of obligations pursuant to Clause 9(c) overrides the termination of obligations by the combined effect of Sections 2(a)(iii) and 6(c)(ii), and thereby seeking to enforce particular Transactions profitable to the Defaulting Party, outside a cross-Transaction close-out, so leaving the Non-defaulting Party with a "gross" exposure on the Transactions in question.

93. In short, the effect of Section 9(c) is that on a termination of any Transaction, whether by performance, agreement or the occurrence of an Early Termination Date, the balance of the parties' obligations, including payment or delivery obligations in relation to un-terminated Transactions, survive, save where the

Transaction has been the subject of an Early Termination Date, in which case only the close-out payment under Section 6(e) remains.

94. The Judge also erred in the following respects. First, by equating the words "*without prejudice to Section 2(a)(iii)*" with the concept of <u>exclusion</u> of Sections 2(a)(iii) and 6(c)(ii) after termination of any Transaction. He thus concluded [79] that "*the exclusion of Section 2(a)(iii) must therefore be a reference primarily to condition (1) (i.e. the default condition)*".

95. This is wrong. As a matter of ordinary language, this is not the meaning of "without prejudice to". "Without prejudice to Section 2(a)(iii)" does not mean that the terms of Section 9(c) apply to the provisions of the Master Agreement *except* Section 2(a)(iii). Instead it means that Section 9(c) does not cut across the effect of an Early Termination Date on payment and delivery obligations that is provided for in Section 2(a)(iii) and Section 6(c)(ii).

96. Secondly, it is impossible to conclude, from the mere fact that the survival of obligations on the termination of any Transaction is without prejudice to Section 2(a)(iii), that Section 9(c) therefore must operate so as to discharge those obligations affected by Section 2(a)(iii). This is a non-sequitur.

97. Thirdly, the Judge concluded [79] that the deliberate use of "termination" with a small "t" was intended to refer to termination by "effluxion of time". ISDA submits that there is no need to imply a concept of "termination by effluxion of time" in order to make sense of Section 9(c)'s reference to "termination". There is no defined term "Termination" in the Master Agreement. Instead, as noted above, there are a variety of ways in which the Transactions, or some of them, may be terminated: by performance, by agreement or by designation or automatic occurrence of an Early Termination Date. The use of a small "t" is to encompass these.

98. Finally, by mis-construing Section 9(c) as he has, the Judge has, in effect, created a new mechanism for the automatic discharge of a Non-defaulting Party's primary obligations under the Master Agreement, which is not contained in its express words. The agreement, however, contains none of the architecture for dealing with the significant consequences of that discharge. Given the detailed and precise nature of the drafting of the termination provisions, and the significant consequences of such a discharge for the close-out mechanism widely relied upon in the derivatives market, such provisions would be expected if such discharge were intended. In addition, the Judge's conclusion raises further questions, for example do the Defaulting Party's obligations survive or are they also terminated?

<u>The Judge's third reason: termination not "early"</u>

99. The Judge's third point is that it is difficult to apply the "Early Termination" provisions after the natural expiry date of a Transaction, because termination after the last date for performance of primary obligations under a Transaction "would not be early in any conceivable sense", and because it was difficult to apply the default method for calculating Early Termination payments where there would be no continuing period in relation to which to obtain a Market Quotation for a replacement swap.

100. Neither of these points withstands scrutiny.

101. There is nothing inapposite in the use of the word "early" as an adjective describing termination. As noted above, it only appears inapposite if it is assumed that a contract 'terminates' through effluxion of time upon the passing of the last date for performance of primary obligations under it. That is, however, not so: while obligations remain unperformed under a contract it cannot be said that it has terminated through effluxion of time. Accordingly, while obligations (including contingent obligations) remain unperformed, it is entirely possible for there to be an 'early' termination of a Transaction which

causes the outstanding obligations to cease to exist, and be replaced with the new obligations (i.e. the payment of the net amount due on close-out of the relevant Transactions) contained in Section 6 of the Master Agreement.

102. Even if that were wrong, it will in most cases be perfectly natural to regard the date as "early". One obvious (and in practice probably common) circumstance in which termination could easily be described as "early" even where it occurred after the last date for performance of a particular Transaction, is where other Transactions between the parties under the umbrella of the Master Agreement had not yet reached the end of their term[42]. The key effect of designating an Early Termination Date under Section 6 is that all (in the case of an Event of Default or certain Termination Events) or some (in the case of certain other Termination Events) Transactions which are then outstanding are closed out and subjected to the netting process. Termination of those ongoing Transactions is most certainly "early" in such a case.

103. Finally, the phrase "Early Termination Date" is in any event merely a label. There is nothing in the operative provisions of the Master Agreement which requires the Early Termination Date to be earlier than the last date for performance of the outstanding Transactions. It is simply a matter of the labels "Early Termination Date" (a defined term) and "Early Termination" (itself not a defined term, but used in the headings of Section 6 and Section 6(e)). Even if in a minority of cases the word "early" might (if the arguments in paragraphs 101 and 102 above are disregarded) appear inapposite, that does not provide a reason to alter the meaning of substantive provisions of the contract relying on the label "Early Termination Date".

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42 The Judge was presented, by the parties below, with two alternative arguments: first that the conditional obligations fell away on the last date for performance under the last Transaction under the Master Agreement; or secondly, that the conditional obligations under a particular Transaction fell away on the last date for performance under that Transaction. He found in favour of the latter.

104. Contrary to the Judge's second concern, there is no difficulty in applying the mechanism for calculating Early Termination payments, where the Early Termination Date is after the last date for performance of primary obligations of the relevant Transaction, or even of all outstanding Transactions. The Judge's concern was that there could be no continuing period, after the end of the Transaction, in relation to which a Market Quotation for a replacement swap could be obtained.

105. The determination of amounts due, however, whether under the Market Quotation method or Loss method, involves two aspects: (1) calculation of the loss or gain represented by the fact that the Terminated Transactions will not continue into the future; and (2) calculation of amounts due historically under the Transaction (or that would have been due but for Section 2(a)(iii)) but not paid (that is, the 'Unpaid Amounts' referred to in paragraph 28 above).

106. The sole consequence of there being no continuing period, because the last day for performance of the relevant Transaction has passed, is that the first aspect of the determination is inapplicable (or necessarily results in a nil figure), so that the calculation focuses solely on the second aspect. The close-out provisions of Section 6(e) are intended to, and do, work perfectly well in such circumstances and it would be erroneous to interfere with this simply because of labelling.

E. Conclusion

107. For these reasons, ISDA would invite the Court of Appeal:

(1) to dismiss KPGZ's cross appeal against the Judge's conclusion that the "one time only" construction of Section 2(a)(iii) was correct;

(2) to reverse the Judge's conclusion that, as a result of the provisions of the Master Agreement, a Non-defaulting Party's obligations are automatically extinguished at the date of the "expiry of the term of the Transaction".

Antony Zacaroli QC

Jeremy Goldring

29 July 2011

3-4 South Square
Gray's Inn
London WC1R 5HP