

Insight: Derivatives

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English Commercial Court Allows Counterparty Contractual Right to Withhold Payments under Section 2(a)(iii) of the ISDA Master Agreement

On 29 October 2009 the High Court (Mr Justice Flaux) handed down its judgment in *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI and another* [2009] EWHC 2656 (Comm) (the "**Marine Trade Case**").

This case provides the first English authority for the proposition that a non-defaulting party may withhold payments under Section 2(a)(iii) of the 1992 ISDA Master Agreement and that payment netting under Section 2(c) of the 1992 ISDA Master Agreement is consequently not available to the defaulting party in such case. The court additionally addressed the circumstances in which amounts paid under protest by a non-defaulting party may be recovered. The Marine Trade Case contrasts with the judgment on 15 September 2009 of the United States Bankruptcy Court in the Southern District of New York in *re: Lehman Bros. Holdings Inc.*, case number 08-13555, as further discussed below.

Case summary

The facts of the Marine Trade Case are summarised as follows:

1. During 2007 and 2008 Marine Trade SA ("**Marine Trade**") and Pioneer Freight Futures Co Ltd BVI ("**Pioneer**") entered into 14 forward freight agreements (the "**FFAs**") governed by the 2007 Terms of the Forward Freight Agreement Brokers Association (the "**FFABA 2007**"), which are a set of standard terms used in the freight derivatives markets. The FFAs are cash settled contracts for differences under which settlement sums are payable monthly.

The FFABA 2007 incorporate and amend the terms of the 1992 ISDA Master Agreement (Multicurrency – Cross Border) (the "**1992 ISDA Master Agreement**") published by the International Swaps and Derivatives Association, Inc. ("**ISDA**"). The contractual agreement between Marine Trade and Pioneer, constituted by the FFABA 2007 incorporating the 1992 ISDA Master Agreement, is referred to herein as the "**Master Agreement**".

2. The settlement sums under the FFAs for the contracting month of January 2009 were as follows:

- (a) around US\$ 7 million was due to Marine Trade from Pioneer; and
- (b) around US\$ 12 million was due to Pioneer from Marine Trade.

This left a potential net balance in favour of Pioneer of around US\$ 5 million. Payment was due on 6 February 2009 and neither party made a payment on this date.



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3. Marine Trade believed that Pioneer was unable to pay its debts as they fell due by the end of January 2009, constituting a bankruptcy event of default under Section 5(a)(vii) of the Master Agreement, and consequently that:
 - (a) Marine Trade's obligation to make a payment to Pioneer was suspended due to the failure to satisfy the conditions precedent to payment under Section 2(a)(iii) of the Master Agreement; and
 - (b) payment netting pursuant to Section 2(c) of the Master Agreement was not available to Pioneer.
4. On 30 January 2009 Marine Trade therefore invoiced Pioneer for the gross amount of US\$ 7 million.
5. However, on 1 February 2009 Pioneer invoiced Marine Trade for the net balance of US\$ 5 million.
6. As Marine Trade did not pay the net balance of US\$ 5 million to Pioneer on 6 February 2009, Pioneer issued a notice that such failure to pay constituted a failure to pay event of default under Section 5(a)(i) of the Master Agreement, thereby providing Pioneer with the right to designate an early termination date under the Master Agreement, closing-out all of the FFAs.
7. Due to the state of the freight market at such time, Marine Trade estimated that its potential liability in such a close-out scenario would have been around US\$ 116 million, substantially greater than the net balance requested by Pioneer.
8. Marine Trade sought, but was refused, an injunction to prevent Pioneer designating an early termination date under the Master Agreement pending trial. As a result in February 2009 Marine Trade paid to Pioneer under protest the net balance of US\$ 5 million in order to avoid the close-out of all of the FFAs.
9. Marine Trade then issued its own notice that Pioneer's failure to pay the gross amount of US\$ 7 million to Marine Trade on 6 February 2009 constituted a failure to pay event of default under Section 5(a)(i) of the Master Agreement. Pioneer had still not made payment of such amount at the time of the judgment.
10. Later in 2009 Marine Trade became itself unable to pay its debts as they fell due, constituting a bankruptcy event of default under Section 5(a)(vii) of the Master Agreement. Pioneer argued that as result of the event of default in respect of Marine Trade its obligation to make the payment of the gross amount of US\$ 7 million to Marine Trade in January 2009 was suspended due to the operation of Section 2(a)(iii) of the Master Agreement.

Were either of the parties bankrupt and if so when?

This was an important question as under the Master Agreement what amounts were payable, by whom and whether any amounts due could be netted depended upon the court's finding as to whether either party was unable to pay its debts as they fell due, i.e. whether a bankruptcy event of default existed in respect of such party under Section 5(a)(vii) of the Master Agreement, and if so at what point in time such event occurred.

This is due to the fact that the payment and delivery obligations of each party under Section 2(a)(i) of the Master Agreement were subject to, among others, the condition precedent in (1) of Section 2(a)(iii), "*each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing*". A non-defaulting party could effectively suspend scheduled payments to a defaulting party for an indefinite period of time due to the failure to satisfy this condition precedent.

The court found that Pioneer was unable to pay its debts as they fell due in February 2009 at the point in time when it demanded the net balance from Marine Trade and that Marine Trade was unable to pay its debts as they fell due from May 2009, each constituting a bankruptcy event of default under Section 5(a)(vii) of the Master Agreement.

Could Marine Trade rely on Section 2(a)(iii) of the Master Agreement to withhold payment from Pioneer? Was payment netting available to Pioneer under Section 2(c) of the Master Agreement? Was Pioneer's payment obligation to Marine Trade affected by Marine Trade's subsequent bankruptcy?

Marine Trade was able to rely on Section 2(a)(iii) of the Master Agreement to withhold payment from Pioneer due to Pioneer's bankruptcy at the time that the payment would have otherwise been due. Flaux J held that *"where Pioneer is affected by an Event of Default, as a consequence of s 2(a)(iii), Marine Trade has no obligation to make payment to Pioneer at all"*.

Regarding Pioneer's assertion of a right to net payments, Section 2(c) of the Master Agreement essentially provided that if on the same date amounts were payable in the same currency and in respect of two or more transactions under the Master Agreement, they could be netted against each other and a single net amount would be payable by one party to the other in satisfaction and discharge of all amounts otherwise payable by the parties.

It was held in the Marine Trade Case that no amount was "payable" by Marine Trade to Pioneer, as required by Section 2(c) of the Master Agreement, due to the continuing event of default in respect of Pioneer and the resultant failure to satisfy the conditions precedent under Section 2(a)(iii). Payment netting under Section 2(c) of the Master Agreement was therefore not available to Pioneer.

Flaux J also held that although Marine Trade itself became bankrupt in May 2009, this did not affect Pioneer's payment obligation to Marine Trade as the conditions precedent in respect of Pioneer's payment obligation under Section 2(a)(iii) of the Master Agreement were satisfied on 6 February 2009. He stated that *"the requirement to satisfy the conditions precedent (under Section 2(a)(iii)) arises only once, at the time that the Settlement Sum falls due, in this case on 6 February 2009"*. Pioneer was therefore in default under the Master Agreement for its failure to pay to Marine Trade the gross amount of US\$ 7 million.

The consequence of these findings is that Marine Trade could have:

- (a) relied on Section 2(a)(iii) of the Master Agreement to withhold from Pioneer the net amount of US\$ 5 million that it paid to Pioneer under protest; and
- (b) insisted upon the payment of the gross amount of US\$ 7 million from Pioneer.

The ability to rely on Section 2(a)(iii) of the 1992 Master Agreement could theoretically result in a non-defaulting party that is out of the money waiting until it is in the money before exercising its right to designate an early termination date under the 1992 ISDA Master Agreement. However, as discussed further below, notwithstanding the above mentioned findings the Marine Trade Case may offer only limited protection to a non-defaulting party.

How much protection does Section 2(a)(iii) of the 1992 Master Agreement provide?

The Marine Trade Case provides authority for the first time under English law that Section 2(a)(iii) of the 1992 ISDA Master Agreement is enforceable in accordance with its terms. This case confirms the previous authority quoted, the Australian case of *Enron Australia v TXU Electricity* [2003] NSWSC 1169 (the "**Enron Case**"), which upheld TXU Electricity's contractual right as the non-defaulting party to rely on Section 2(a)(iii) of the 1992 ISDA Master Agreement so as not to make any further payments under a swap transaction, by the court holding that it did not have the power to make an order to compel TXU Electricity to designate an early termination date under the 1992 ISDA Master Agreement between the parties. Enron Australia was at the relevant time subject to an administration and a subsequent liquidation.

It is worth noting that the Marine Trade Case is only a first instance judgment and it did not deal with a party subject to formal insolvency proceedings. Furthermore, neither the Enron Case nor the Marine Trade Case specifically addressed the question of whether Section 2(a)(iii) can be relied on indefinitely or for a significant period of time. These concerns are discussed further below.

Additionally, the Marine Trade Case may in practice offer limited protection to a non-defaulting party that is out of the money. As mentioned, Marine Trade's withholding of payment pursuant to Section 2(a)(iii) was interpreted by Pioneer as a failure to pay constituting an event of default under the Master Agreement. Pioneer's remedy in such a situation would have been to designate an early termination date thereby closing out all outstanding FFAs under the Master Agreement and causing a substantial sum to become payable by Marine Trade. Marine Trade sought an interim injunction, pending the outcome of the dispute between the parties, to prevent Pioneer effecting the close-out, however, this was refused. Flaux J stated

“(t)he application for an injunction was refused by Field J, essentially on the grounds of the potentially disastrous effect such an injunction could have on Pioneer’s cash flow.”

The primary concern for Field J appears not to have been whether Section 2(a)(iii) of the 1992 ISDA Master Agreement could be found to be legally operative, but whether the granting of an injunction could jeopardise Pioneer’s financial stability and hasten its bankruptcy. One can perhaps see the judge’s logic - why should a company on the verge of bankruptcy that is potentially owed a large amount of money be prevented from recovering it and thus avoiding the disaster? However, such a decision seems to go against the commercial intent of the parties and the terms of the Master Agreement. It effectively forced Marine Trade to make the payment to Pioneer in order to avoid the risk of paying a far greater sum. It may be that in future cases of a similar nature, the authority provided by the Marine Trade Case will allow the party in Marine Trade’s position the ability to actually rely on Section 2(a)(iii) of the 1992 ISDA Master Agreement.

Is there any way that Marine Trade could have recovered the money it paid over to Pioneer under protest?

The position of the non-defaulting party is further weakened in the circumstances of the Marine Trade Case by the fact that there appears to be very limited grounds for the recovery of money paid out under protest. English law does not recognise an action for the recovery of money on the ground that it was not due. Instead it recognises only an action for the recovery of money paid under a mistake of fact or law, and under certain forms of compulsion. It was held in the Marine Trade Case that money paid out under protest will not amount to a mistake, as Marine Trade believed at the time of payment that more likely than not it did *not* have to make such payment and so was not mistaken. This leads to the

problematic conclusion that the more certain a party is that it should *not* have to pay the money, the less likely it is to be mistaken and consequently the less likely it will be able to recover the money.

It remains to be seen whether Marine Trade could have successfully argued that any threat of close-out of the FFAs by Pioneer amounted to duress.

At this stage, the only clear way of addressing this issue may be to include an express contractual provision in a 1992 ISDA Master Agreement that a sum of money paid over by a party should be repaid by the recipient if it is subsequently found that it did not have to be paid over. There is some authority for such a result in *Sebel Products Ltd v Commissioners of Customs and Excise* [1949] 1 All ER 729. This wording was not included in the Master Agreement in the Marine Trade Case.

Can a party rely on Section 2(a)(iii) of the 1992 ISDA Master Agreement indefinitely or for a long period of time or in the context of formal insolvency proceedings?

Whilst the Marine Trade Case establishes that Section 2(a)(iii) of the 1992 ISDA Master Agreement is valid under English law, it offers no guidance on whether a party can rely on Section 2(a)(iii) indefinitely or for a long period or time or and in the context of formal insolvency proceedings. This lack of clarity under English law was mentioned also in the HM Treasury consultation paper “Establishing resolution arrangements for investment banks” dated 16 December 2009. It was stated that market participants recognise the benefit of a non-defaulting party being able to suspend payments pursuant to Section 2(a)(iii) of the ISDA Master Agreement after an initial default by a counterparty, thereby avoiding an increase in potential losses by making further payments to the

counterparty and allowing the orderly termination of outstanding transactions between the parties. That said, this provision should be tempered to provide certainty to administrators of insolvent estates that the termination of outstanding transactions will eventually occur and to avoid the use of this provision as a “walk away” clause by non-defaulting parties. The Government has also mentioned in such paper that unless an adequate market solution is found for this problem, it may choose to intervene, which may take the form of requiring bar dates, for example.

The question of the treatment of Section 2(a)(iii) of the 1992 ISDA Master Agreement in a formal insolvency proceeding has been addressed by the United States Bankruptcy Court in the Southern District of New York in *re: Lehman Bros. Holdings Inc.*, case number 08-13555 (the “**Metavante Case**”). In the Metavante Case the court found that a party could not rely on Section 2(a)(iii) to withhold payments to a party the subject of a formal insolvency proceeding and reached its conclusion based on the provisions of the United States Bankruptcy Code (the “**Code**”).

A brief summary of the Metavante Case follows, however for further guidance please [click here](#).

In the Metavante Case, the Metavante Corporation (“**Metavante**”) had entered into an interest rate swap transaction under a 1992 ISDA Master Agreement with Lehman Brothers Special Financing Inc. (“**LBSF**”), which was guaranteed by Lehman Brothers Holdings Inc (“**LBHI**” and together with LBSF, “**Lehmans**”). Following the Lehmans bankruptcy filing, Metavante had ceased to make payments to LBSF under the swap in reliance on Section 2(a)(iii). It argued that neither the 1992 ISDA Master Agreement nor the Code required it to exercise its right to terminate the interest rate swap within a specific timeframe to preserve the protection afforded to it by the safe harbour provisions under the Code.

The court held that the suspension of payments by Metavante pursuant to Section 2(a)(iii) of the 1992 ISDA Master Agreement was in violation of the automatic stay provisions of the Code, in that it modified an executory contract solely because of the bankruptcy filing of Lehmans and that it was not protected by the applicable safe harbour provision due to its delay in exercising its right to terminate the outstanding transaction. The court stated that Metavante's conduct was contrary to the spirit of the safe harbour provisions of the Code. ISDA itself published a memorandum to its documentation committee on 30 September 2009 stating that nowhere in the 1992 ISDA Master Agreement does it state that Section 2(a)(iii) allows a non-defaulting party to stand still forever on its suspension of payments to the defaulting party. Unfortunately, as it has been pointed out in commentary since such time, nowhere in the 1992 ISDA Master Agreement does it state that the non-defaulting party cannot rely on Section 2(a)(iii) of the 1992 ISDA Master Agreement indefinitely or for a long period of time.

Needless to say the Code and English insolvency law are different. There are no direct equivalents under English insolvency law to the automatic stay and safe harbour provisions of the Code. That said, there are principles of English insolvency law, such as the anti-deprivation rule, which may have an effect on the ability of a party to rely on Section 2(a)(iii) of the ISDA Master Agreement.

If an event of default is continuing but is subsequently cured, are the conditions precedent under Section 2(a)(iii) of the 1992 ISDA Master Agreement satisfied and does a payment obligation then arise?

Pioneer had initially argued that even if it was affected by an event of default as at 6 February 2009 and thereby at such time pursuant to Section 2(a)(iii) of the Master Agreement no amount was payable by Marine Trade to Pioneer, at a later date it was no longer affected by such event of default, and at that time Marine Trade's payment obligation which had been suspended during the period of default, accordingly accrued. Pioneer later accepted that it was affected by an event of default at all material times, however Flaux J offered an opinion on this point in obiter dicta.

It had previously been thought that the subsequent cure of an event of default would mean that the condition precedent in (1) of Section 2(a)(iii) of the 1992 ISDA Master Agreement would be satisfied and an otherwise suspended payment obligation would arise, however Flaux J stated that Sections 2(a)(i) and (a)(iii) are "one time" provisions for the calculation and assessment at the end of the Contract Month of whether a sum is owed." No payment obligation would have arisen had the circumstances been as Pioneer had first argued. This statement is obiter and subsequent cases on the point may find differently, however, it is worth noting that the statement goes against the view of how many had previously thought Section 2(a)(iii) of the 1992 ISDA Master Agreement would operate.

Conclusion

The Marine Trade Case provides authority for the first time under English law that Section 2(a)(iii) of the 1992 ISDA Master Agreement is valid, however the court has given little guidance on how a party could practically use this contractual right to its advantage. For various reasons, including those mentioned above, reliance on Section 2(a)(iii) of the ISDA Master Agreement should still be exercised very cautiously.

An appeal of the Marine Trade Case is expected to take place in mid to late 2010 and it will be interesting to observe whether the Court of Appeal is prepared to provide more favourable ground for the non-defaulting party.

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