On June 19, the International Swaps and Derivatives Association (ISDA) published a long-awaited standard amendment to Section 2(a)(iii) of the ISDA Master Agreement (the Master Agreement). Section 2(a)(iii) of the Master Agreement (Section 2(a)(iii)) is a condition precedent that suspends a non-defaulting party’s obligation under the Master Agreement to make a payment or delivery to a defaulting party if there is a continuing Event of Default or Potential Event of Default. Whereas the suspension under Section 2(a)(iii) continues until such default is cured — and potentially indefinitely — ISDA’s Section 2(a)(iii) amendment (the Amendment) limits the length of the suspension under Section 2(a)(iii). The Amendment and ISDA’s Guidance Note are available in the ISDA Bookstore, here.

For those market participants that have not already addressed the lingering Section 2(a)(iii) issues, the Amendment will provide an added degree of certainty with respect to the time frame of Section 2(a)(iii). All parties, however, should be aware of and consider the outstanding issues outlined below.

Background

For many years, the Master Agreement has served as the industry standard for market participants to document the terms of their over-the-counter swaps. Under the Master Agreement, if there is a continuing Event of Default (e.g., failure to pay, cross default, bankruptcy), a counterparty has the right to (1) terminate the agreement; or (2) exercise a “wait and see” option under Section 2(a)(iii), which permits the non-defaulting party to suspend payment or delivery until the default is cured. Under the second scenario, a non-defaulting party could potentially suspend payment/delivery indefinitely or until the contract terminates. This scenario has been the subject of judicial interpretation and the cause of uncertainty for counterparties in various jurisdictions, particularly when the relevant default is tied to a bankruptcy or insolvency proceeding.

The interplay between Section 2(a)(iii) and the bankruptcy laws in the United States and abroad has caused some uncertainty for market participants with respect to the length of operation of Section 2(a)(iii) in the event of a bankruptcy default, as demonstrated in the following landmark cases:

- **Enron Australia v. TXU Electricity:** The Australian Supreme Court of New South Wales was one of the first courts to examine the application of Section 2(a)(iii) in the context of a bankruptcy. Enron Australia and TXU were counterparties to several electricity swaps (for which Enron was in the money) under a 1992 Master Agreement. In 2002, Enron entered into an insolvency proceeding, causing an Event of Default under the Master Agreement. TXU chose not to terminate the Master Agreement (which would have required TXU to pay a settlement amount to Enron), but rather...
to suspend its payment obligations in reliance on Section 2(a)(iii). The Australian Supreme Court denied Enron’s petition to force TXU to designate an Early Termination Date and thus make an early termination payment to Enron. The court reasoned that, under Australian laws, it did not have the authority to “vary the parties’ vested contractual rights” that permitted TXU to suspend payment. Thus, the court concluded that a non-defaulting party may exercise its rights under Section 2(a)(iii) “for as long as an Event of Default continues.” The court provided some relief and clarity to Enron Australia, however, by agreeing that, under the negotiated Additional Termination Events terms in the parties’ Master Agreement, upon the expiry of the last outstanding transactions, Enron could declare an Early Termination Date and collect any amounts owed. Thus, TXU could not escape payment indefinitely in this case.  

• In re Lehman Brothers Holdings, Inc. (the Metavante Case): The Lehman Brothers bankruptcy case provided the first instance in which a U.S. court considered the Section 2(a)(iii) condition precedent in the context of a bankruptcy case. After Lehman filed for bankruptcy protection, its swap counterparty, Metavante Corporation, withheld payment for approximately one year in reliance on Section 2(a)(iii). Metavante, which was out-of-the-money, later attempted to terminate the agreement pursuant to the safe harbor provisions in the Bankruptcy Code. The bankruptcy court found that Section 2(a)(iii) was unenforceable in bankruptcy when triggered by a bankruptcy default, because of a statute that prohibits the modification of contractual rights due to a bankruptcy. While the Bankruptcy Code’s safe harbor statutes preserve the right to terminate a swap, the court reasoned that they do not affect the prohibition on modifying the swap. The court further declined to allow Metavante’s purported termination, because it concluded that contractual termination rights must be exercised “promptly” after a defaulting party’s bankruptcy filing.  

• Lomas v. JFB Firth Rixson Inc. After a series of conflicting lower court cases in England, the English Court of Appeals provided guidance on the operation of Section 2(a)(iii) in the context of the bankruptcy administration of Lehman Brothers International. In Lomas, the court concluded that a non-defaulting party’s payment/delivery obligations may be suspended (but not extinguished) under Section 2(a)(iii) until the Event of Default is cured. Because the court found there was no reasonable expiry of the operation of Section 2(a)(iii) implied in the contract, it concluded that the suspension of payment/delivery obligations under Section 2(a)(iii) can be for an indefinite period of time.  

The cases summarized above represent the extreme outcomes for Section 2(a)(iii) – either that it is rendered completely unenforceable, as in Metavante, or that it allows for indefinite suspension, as in Lomas. With the Amendment, ISDA aims to navigate a middle course between those two extremes by allowing suspension of payment/delivery obligations for a limited period of time.
The Amendment

The Amendment provides some certainty to Master Agreement counterparties with respect to the length of operation of the Section 2(a)(iii) condition precedent. The Amendment operates as follows.

Upon the occurrence of an Event of Default, the Amendment allows the defaulting party to provide notice to the non-defaulting party, thereby establishing a “Condition End Date.” The Condition End Date will serve as a time limit on how long the non-defaulting party may suspend payment or delivery in reliance on Section 2(a)(iii). ISDA proposes a 90-day limit for determining the Condition End Date, but the Amendment permits the parties to negotiate the Condition End Date term. Upon the expiry of the Condition End Date, the non-defaulting party must resume payment or delivery on the first Local Business Day after the Condition End Date, with interest or compensation as applicable.

The Amendment further provides that if a subsequent Event of Default or Potential Event of Default occurs with respect to the defaulting party, then the Condition End Date for any initial Event of Default is void (except where such initial Event of Default is a bankruptcy default), and the defaulting party must provide a new notice to establish a new Condition End Date for the subsequent Event of Default. If a subsequent Event of Default is cured and the initial Event of Default still exists, however, then the defaulting party may give a new notice with respect to the initial Event of Default that is outstanding and thus reestablish a Condition End Date for that initial default.

Outstanding Issues and Other Considerations

Since the Enron Australia ruling, many parties have negotiated, in the Schedules to their Master Agreements, language that limits a non-defaulting party’s ability to rely indefinitely on Section 2(a)(iii) without designating an Early Termination Date. There seems to be no compelling reason to replace those negotiated provisions with the Amendment. However, absent such negotiated provisions, the Amendment provides a reasonable solution for firms that wish to align their Master Agreements with certain case law and have some clarity with respect to the length of operation of Section 2(a)(iii). Market participants considering the Amendment should, however, be aware of the following issues:

• Application of Amendment When There is a Dispute Regarding an Event of Default: The Amendment could be problematic where there is a bona fide dispute between the parties on whether or not an Event of Default has occurred. In order to obtain relief from the withholding of payments pursuant to Section 2(a)(iii) as contemplated by the Amendment, it appears that a party expecting to receive payments would have to concede that an Event of Default has occurred. This situation could be avoided by adopting an alternative provision that puts the onus on the party withholding payments pursuant to Section 2(a)(iii) to resume payments if it does not
designate an Early Termination Date within a specified period.

- **Uncertainty Regarding a Continuing Failure to Make a Payment During an Event of Default:** When a party triggers one Event of Default, it is not unusual for that party to trigger additional Events of Default as time passes. As noted above, each subsequent Event of Default could result in an extension of the Condition End Date. This result appears contrary to the purpose of the Amendment, because it could result in a non-defaulting party withholding payment/delivery over an extended period of time. Again, a provision could be drafted that would preclude this result.

- **Ongoing Uncertainty Under U.S. Bankruptcy Law.** The principle underlying the *Metavante* decision was that U.S. bankruptcy law voids any modification of contractual terms that is triggered by a bankruptcy filing. Although the Amendment surely makes a non-defaulting party’s actions appear more reasonable than the use of Section 2(a)(iii) without the Amendment, the rationale of the *Metavante* ruling appears to hold true in either scenario. There remains a risk, therefore, that a bankruptcy court will deny a non-defaulting party’s attempt to suspend payment or delivery, even under the Amendment.

- **Primary Intent of Amendment.** According to the ISDA “Guidance Note,” officials in the UK Treasury were the key motivators behind the development of the Amendment. The British regulators feared that *Lomas* would harm liquidators’ ability to pay creditors because of their inability to monetize in-the-money positions from non-defaulting parties that rely on Section 2(a)(iii).

For parties that have not already addressed this issue in their Master Agreement schedules, the Amendment provides an additional option for clarifying the length of operation of Section 2(a)(iii) with respect to most Events of Default under the Master Agreement. Although some uncertainty remains concerning the validity of Section 2(a)(iii) and the operation of the Amendment in the context of a bankruptcy default in the U.S., counterparties should still consider adopting the Amendment (or a negotiated provision similar to the Amendment) to address the operation of Section 2(a)(iii) in non-bankruptcy default situations.

1. The Section 2(a)(iii) amendment is available for both the 1992 and 2002 Master Agreements.
2. Capitalized terms not defined herein have the meanings set forth in the Master Agreement.
3. For example: following an Event of Default, the non-defaulting party can elect to terminate the Master Agreement by designating an Early Termination Date, or exercise its right to cease making payments or deliveries in reliance on Section 2(a)(iii). Under the Amendment, however, if the non-defaulting party elects the latter, it can only suspend payment/delivery for a limited period of time. The non-defaulting party cannot both decline to terminate and withhold payments indefinitely because this would effectively negate the two-way payments contemplated upon early termination of an ISDA Master Agreement.
4. It is rare that a bankruptcy Event of Default (Section 5(a)(vii) of the Master Agreement) can/will be cured; therefore, theoretically, a non-defaulting party that suspends payment/delivery as a result of a bankruptcy event of...
default pursuant to Section 2(a)(iii) could do so indefinitely.


10 Note that the court’s conclusion with respect to payments upon the expiry of the transactions is specific to the negotiated Additional Termination Events provisions in the Master Agreement between Enron Australia and TXU. Absent such negotiated provisions (most Master Agreements do not have such provisions), this case may lead to an indefinite postponement of payment obligations under Section 2(a)(iii).

11 See In re Lehman Bros. Holdings, Inc., case number 08-13555. For additional information on the Metavante case, see Sutherland’s September 29, 2009 Legal Alert.

12 Section 560 of the Bankruptcy Code permits a qualifying non-debtor party to a swap contract to liquidate, terminate or accelerate a swaps contract in the event of a Chapter 11 bankruptcy filing, notwithstanding the automatic stay.

13 See Section 365(e) of the Bankruptcy Code.

14 Section 365(e) of the Bankruptcy Code.

15 See Lomas and others v. JFB Firth Rixson Inc and others, [2012] EWCA Civ 419. ISDA submitted two amicus briefs to the English Court of Appeals in the Lomas case. See ISDA’s First Written Submission (July 29, 2011), and ISDA’s Second Written Submission (Oct. 25, 2011), both available here.

16 The Section 2(a)(iii) amendment also applies to a Potential Event of Default. If a Potential Event of Default has occurred and is continuing, the defaulting party must waive its right to receive certain notices from the non-defaulting party under the Master Agreement, and thus the Potential Event of Default is deemed an Event of Default for which the non-defaulting party may establish a Condition End Date.

In the event of ongoing payment defaults, this may not be significant because the non-defaulting party may not need to rely upon Section 2(a)(iii) if the only payments due are from the defaulting party. Where there are multiple transactions, some in-the-money and some out-of-the-money, the extension of the Condition End Date could be problematic. For example, assume Parties A and B have entered into two swaps: (1) Swap 1, which provides for mid-month monthly payments, and (2) Swap 2, which provides for end-of-month quarterly payments, and Party B has defaulted on a monthly swap payment. The market-to-market (MTM) value of Swap 1 is a positive $2 million for Party A, and the MTM value of Swap 2 is a negative $10 million. In this case, Party A can withhold making payments on Swap 2, and subsequent defaults by Party B on payments with respect to Swap 1 will continue to extend the Condition End Date.

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