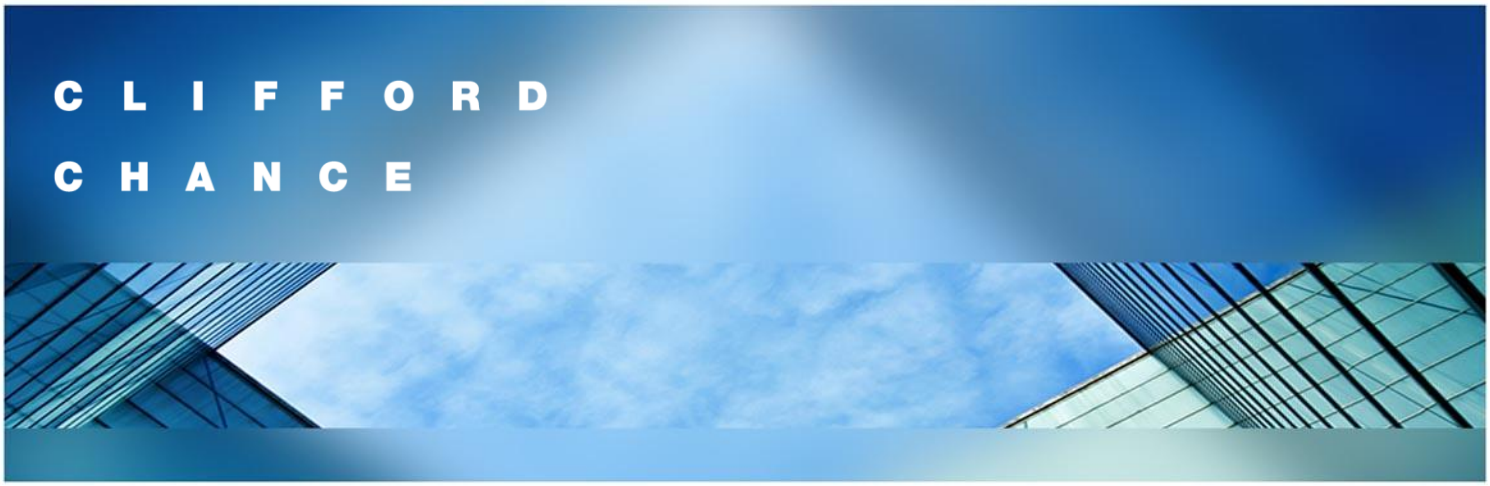

SURVIVING INSOLVENCY – UK LEHMAN DECISION ON ISDA BANKRUPTCY EVENTS OF DEFAULT

Lehman's insolvency will shortly cease to be "continuing" for the purposes of the ISDA Master Agreement. This may mean that payments owed to Lehman but suspended under section 2(a)(iii) of the Master Agreement will again become due for payment, more than fourteen years after Lehman's collapse.

Key issues

- When Lehman exits administration the suspension of payments under the standard ISDA comes to an end, and sums are liable to be paid
- Statutory set-off extinguishes underlying debts, leaving only a claim for the balance
- Admission of inability to pay debts could be cured by public statement that this was no longer the case
- Once the administration ends in solvent recovery, the bankruptcy event of default comes to an end
- Assignments, arrangements or compositions that are not triggered by financial distress or fundamental change of status are not bankruptcy events of default

In *Grant v FR Acquisitions Corporation (Europe) Ltd* [2022] EWHC 2532 (Ch), a judge decided that an administration is no longer continuing for the purposes of section 2(a)(iii) of the ISDA Master Agreement when the administration itself formally ends, even if the effects of the administration continue to be felt by creditors. He decided that an arrangement or composition with creditors will only be an "Event of Default" for the purposes of the ISDA Master Agreement if it is proposed in circumstances of financial distress, not in a context that has no impact on credit risk. But if a scheme is done in that context, it may continue permanently. The decision also makes clear that any foreign law recognition of the insolvency proceedings or the scheme are not to be considered to be standalone events of default.

Lehman and the ISDA Master Agreement

When the Lehman group failed in September 2008, its principal UK arm, LBIE, went into administration, which constituted an Event of Default under the ISDA Master Agreement. The terms of the Master Agreement gave LBIE's counterparties a choice in these circumstances: they could rely on the Event of Default to terminate all transactions subject to the Agreement; or they could rely on section 2(a)(iii) of the Master Agreement to suspend their payment obligations to LBIE for so long as an Event of Default was "continuing". (Counterparties could also have looked to their remedies under the general law, preserved by the section 9(d) of the Master Agreement, such as termination for repudiatory breach, if available.)

Where calculations were such that on an aggregate net basis LBIE owed the counterparty money on the transactions subject to the Master Agreement, the choice for the counterparty was usually easy: terminate the transactions. Back in 2008 it was considered that there was little prospect of LBIE paying sums owed under individual transactions as the sums fell due, and so in general it was simpler to crystallise the loss by termination, which would also have the beneficial effect of netting in the money transactions against out of the money transactions in order to settle (or partially settle) any payments owed by LBIE. Once the amount had been crystalised, the counterparty could then wait for

such dividend as LBIE might pay. As matters have turned out, LBIE has paid in full, with interest, though it took a number of court cases and a scheme of arrangement to finalise the payments.

If, on an aggregate net basis, the result favoured LBIE, the position was not so straightforward for counterparties. Why terminate transactions if doing so would lead to an obligation to pay LBIE money? There was no continuing obligation to make transaction payments to LBIE as a result of section 2(a)(iii) of the Master Agreement, which makes it a condition precedent to payment that no Event of Default with respect to the other party "has occurred or is continuing". The fixed rate payer on an interest rate swap entered into with Lehman before September 2008 was likely to be out of the money, the cause being, ironically, the reduction in interest rates flowing from Lehman's collapse.

LBIE's administrators did not like reliance on section 2(a)(iii) because it meant that any value in transactions was lost to LBIE (even if that value was caused by Lehman's demise), for so long as an Event of Default was "continuing" and the provisions of section 2(a)(iii) were in operation. The administrators made an early attempt to limit the consequences of section 2(a)(iii) by arguing, amongst other things, that the suspension ceased when the transaction would otherwise have come to an end. The Court of Appeal did not accept this argument, concluding that transactions could be suspended by section 2(a)(iii) indefinitely (*Lomas v JFB Firth Rixson* [2012] EWCA Civ 419). As long as an Event of Default was continuing, the suspension under section 2(a)(iii) continued. The decision led to ISDA's 2014 Protocol, allowing parties by agreement to limit the time during which a party could rely on section 2(a)(iii).

Lomas v JFB Firth Rixson left it open to the administrators to argue that, if LBIE's administration came to an end, there would be no continuing Event of Default and section 2(a)(iii) would no longer apply. The counterparty's payment obligations would therefore revive even if, as in the case in point, the transactions would otherwise have run their course in 2010. This time the administrators succeeded: *Grant v FR Acquisitions Corporation (Europe) Ltd* [2022] EWHC 2532 (Ch). LBIE is solvent, with a surplus available to its shareholders. The administrators intend to terminate their appointment and return the company to the care of its directors. The Event of Default will no longer continue, and the payment suspension under section 2(a)(iii) will end.

An end of continuation?

To succeed in their argument, LBIE's administrators had to show that, on the cessation of LBIE's administration there would be no continuing events of default of any sort under the Master Agreement. There had been a number of events of default with regard to LBIE in addition to the administration itself.

First, there were payment defaults by LBIE, an Event of Default under section 5(a)(i). The judge decided that these had ceased to be continuing in December 2009 because of the effect of insolvency law. Under Insolvency Rule 14.24, if distributions to creditors are made by administrators, as happened in LBIE's administration, there is first a mandatory set-off of all mutual debts in order to calculate the balance due. The effect of this set-off is to extinguish the underlying debts, leaving only a claim for the balance. In FR Acquisitions Corporation (Europe), the sums owed by LBIE were significantly less than the sums owed to LBIE, resulting in a single net sum due to LBIE. The set-off meant that LBIE was therefore no longer in payment default under

the ISDA Master Agreement, and there was no "continuing" non-payment Event of Default.

Secondly, LBIE had admitted in writing that it was unable to pay its debts as they fell due, which was an Event of Default under section 5(a)(vii)(2). The judge considered that this Event of Default would cease to be continuing if it was obvious that it was no longer the case. If necessary, it could be cured by making a public statement that it was no longer the case.

Thirdly, there was the administration itself, an Event of Default under section 5(a)(vii)(6). The judge decided that it was necessary to look at the state of affairs that constituted the Event of Default and determine whether that was continuing. The issue is not whether the event continues to have an effect on creditors' rights. On a plain reading of the documentation, quite simply if the administration came to an end, the Event of Default constituted by the administration would come to an end even if consequences arising from the administration live on.

Fourthly, there was the scheme of arrangement that ended the disputes about, amongst other matters, the interest owed by LBIE under the ISDA Master Agreement. It is an Event of Default under section 5(a)(vii)(3) if a party "makes a general assignment, arrangement or composition with or for the benefit of creditors". The judge decided that this only applied to an arrangement triggered by financial distress or involving a fundamental change of status (such as dissolution or winding-up). LBIE's scheme dealt with the quantification of claims to its surplus and was aimed at ending the numerous pieces of litigation about the surplus. It was not in the context of a lack of funds: LBIE was solvent. The issue was the reverse, and was not therefore an Event of Default.

The judge added, however, that had he decided that the scheme of arrangement was an Event of Default, he would have decided that it continued as long as the scheme had effect, potentially permanently.

As a result, when LBIE comes out of administration, there will no longer be a continuing Event of Default under the ISDA Master Agreement, and the suspension of payments under section 2(a)(iii) will come to an end. In FR Acquisitions Corporation (Europe) the result is that principal amounts of over £8 million under a sterling interest rate swap (governed by the 1992 version of the Master Agreement) and $53 million under a US dollar interest rate swap (governed by the 2002 version of the Master Agreement), on which LBIE was the floating rate payer, will or may fall due. The spectre of interest should not be forgotten and the operation of the Master Agreements may yet result in an increase in the amounts owing to LBIE, even if the approach for determining interest payable under each transaction takes a diverging path as a result of the differences between the drafting of the 1992 and 2002 versions of the Master Agreement.

Conclusion

The circumstances surrounding LBIE's administration are unusual. Companies only go into administration if they are, or are likely to become, unable to pay their debts. Few companies come out of an administration at all (they are usually liquated or dissolved), let alone showing a healthy surplus for shareholders. That is, however, what LBIE has done. The judge's interpretation of the ISDA Master Agreement that an administration (or other

insolvency) only continues while the administration order is in force may, perhaps, be of limited direct relevance in future.

The judge did, however, lean generally in favour of an Event of Default being capable of no longer continuing. The alternative argument that, for example, a failure to pay a sum on its due date is inherently incapable of being cured because payment could never again be made on that date, is commercially unattractive. Looking at the state of affairs that constitute the Event of Default – such as non-payment – and considering whether that state of affairs continues allows most events of default to be cured.

Similar default triggers and the concept of those defaults continuing also appear in other financial contracts, so the decision may also be of interest beyond the confines of the derivatives market. Many, though not all, such agreements specify that an "Event of Default" will be "continuing" unless and until waived, whereas a "Default" or "Potential Event of Default" will be "continuing" unless and until remedied or waived. That form of wording was not before the judge in this case, though the judgment is likely still to be relevant where a waiver is not required.

Likewise, of greater wider relevance may be the judge's interpretation of a "general assignment, arrangement or composition with or for the benefit of creditors" as only applying in an insolvency or similar context. Section 5(a)(vii) of the ISDA Master Agreement is headed "Bankruptcy" and most of the other events of default listed are obviously insolvency related, so it is not surprising an "arrangement" should be limited in that way. This interpretation will, however, be of comfort to solvent companies wanting to enter into a process that could be described as an arrangement or composition for the benefit of creditors, but not wanting to risk an Event of Default. While it is not addressed in this particular case, the reasoning arguably supports the difference in approach under the Master Agreement between "Events of Default" (which are credit-related events) and "Termination Events" (which are regarded as externally induced non-credit/fault based events).

But, of course, the sums at stake in this case are such that a trip to the Court of Appeal may be in the offing.

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