Penn State International Law Review

Volume 29
Number 3 *Penn State International Law Review*

Article 9

1-1-2011

Global Financial Transactions and Jurisdictional Fragmentation: Inconsistent Decisions by Leading Trans-Atlantic Courts

Agasha Mugasha

Follow this and additional works at: http://elibrary.law.psu.edu/psilr

Part of the International Law Commons

Recommended Citation

Mugasha, Agasha (2011) "Global Financial Transactions and Jurisdictional Fragmentation: Inconsistent Decisions by Leading Trans-Atlantic Courts," *Penn State International Law Review*: Vol. 29: No. 3, Article 9.
Available at: http://elibrary.law.psu.edu/psilr/vol29/iss3/9

This Article is brought to you for free and open access by Penn State Law eLibrary. It has been accepted for inclusion in Penn State International Law Review by an authorized administrator of Penn State Law eLibrary. For more information, please contact ram6023@psu.edu.

Global Financial Transactions and Jurisdictional Fragmentation: Inconsistent Decisions by Leading Trans-Atlantic Courts

Agasha Mugasha[1]

Table of Contents

INTRODUCTION—LEGAL FRAGMENTATION OF COURTS: USE OF EXTRA-JUDICIAL DIALOGUE TO RESOLVE A CLASH OF DECISIONS 553
BUSINESS AND LEGAL BACKGROUND— GLOBALIZED FINANCIAL INDUSTRY CONGLOMERATES OPERATING IN A FRAGMENTED LEGAL LANDSCAPE 556
Business Features of Cross-Border Transactions 556
FINANCIAL TRANSACTIONS IN THE COURTS 560
Metavante 561
Lehman Brothers—*UK Litigation* 567
Lehman Brothers—*US Litigation* 571
CONCLUSION 575

INTRODUCTION—LEGAL FRAGMENTATION OF COURTS: USE OF EXTRA-JUDICIAL DIALOGUE TO RESOLVE A CLASH OF DECISIONS

Courts in common-law countries throughout history have been aware that they make law and influence commercial practice. They see their role as extending beyond the adjudication of the particular dispute

1. LLB (Hons), Makerere; Dip LP (LDC); LLM, Ph.D. (Osgoode Hall Law School, York University, Canada; Advocate (Uganda); Professor of Commercial Law; Director, Centre for Commercial Law, University of Essex. I am ever so grateful to Professor Benjamin Geva and Osgoode Hall Law School of York University for initiating me into the exciting world of innovative financial transactions and to the many legal practitioners and bankers for their generosity with time and knowledge that gives me sustenance. The law firm of Clifford Chance stands out for specific mention for permitting me to join the Legal Perspectives seminar programme and generosity with information. The research assistance of Aysem Diker Vanberg is also gratefully acknowledged.

between the immediate parties to the guidance of future activity, and many courts have embraced this task with great responsibility.[2] In this regard, leading courts in the major financial centres make global commercial law. In some recent litigation concerning international financial transactions, national courts have been sensitive to the relevance of other jurisdictions and have expressed a willingness to understand what happens in these jurisdictions.[3] This has been a welcome approach because financial transactions have grown in size and complexity, and the largest and most spectacular of them all tend to be cross-border transactions requiring a resolution that is satisfactory across a number of jurisdictions. In times of economic prosperity, contracting parties are usually ready to re-negotiate and re-structure contracts rather than to litigate; such a general approach changes dramatically when there is the prospect of insolvency of one of the parties or a general economic downturn in an individual country or a global economic downturn.

In equal measure, courts have for generations endeavoured to learn and apply what the commercial industry has done in practice in an endeavour to facilitate commerce, finance and economic prosperity.[4] Frequently the courts and industry work in tandem in this process of mutual education and feedback, but sometimes clashes do occur—when courts overrule a widely held perception of industry practice[5] or when the industry works around court decisions that are considered erroneous.

This article notes the problem of conflicting court decisions that arise from the fragmentation of the legal landscape while the financial industry operates on a more or less integrated global basis via a network of closely linked national and regional financial centres. Additionally, the article focuses on three recent cases decided in the two leading financial centres of London and New York in the aftermath of the recent

---

2. *See* Power Curber Int'l. v. Bank of Kuwait SA [1981] 1 WLR 1233; Hortico (Australia) Pty Ltd. v. Energy Equipment Co. Pty Ltd. (1985) 1 NSWLR 545 (Sup. Ct.) (Austl.).

3. *See e.g.*, Law Debenture Trust Corporation Plc v Concord Trust, [2007] EWHC 2255 (Ch) involving an anti-suit injunction; *see also* AON Financial Products, Inc v. Societe Generale 476 F.3d 90 (2d Cir. 2007) (where the Second Circuit Court of Appeals reversed a trial decision after ISDA submitted an amicus brief. Joanna Benjamin & David Rouch, *The International Financial Markets as a Source of Global Law: the Privatisation of Rule-making?* 2 L. & FIN. MARKETS REV. 78, 84 n.27 (2008) (the amicus brief pointed out that "The District Court's errors in this case are of such fundamental nature that they cast significant doubt on the operation of credit default swap contracts. The rulings are directly contrary to the settlement mechanics set forth in ISDA's standard documentation that is used in this $17.1 trillion market.").

4. The best known English judge in this regard might be Lord Mansfield, who was called "the father of commercial law in this country" in Lickbarrow v. Mason (1787) 2 TR 63, 73 but there are many more judges that have followed that tradition.

5. *See, e.g.*, Hazell v. Hammersmith and Fulham London Borough council [1992] AC 1 (HL); (appeal taken from Queens Bench).

global financial crisis ("GFC"). All three cases arose from pre-GFC transactions that went sour because of the bankruptcy and later collapse of US investment bank Lehman Brothers. One of the cases pitted the provisions of the US Bankruptcy Code against those of the International Swap and Derivatives Association ("ISDA") Master Agreement, one of the most widely used standard form documents in the world. This case, *Metavante*,[6] is considered one of the most significant decisions concerning the rights of the parties in over-the-counter derivatives following a bankruptcy event of default. The significance of this case is three-fold. First, the decision tested the application the ISDA Master Agreement in the commercially important jurisdiction of New York. Second, within the US, the decision triggered a number of cases that were based on roughly the same facts.[7] Third, in a global setting the decision has opened up a debate on some provisions of the ISDA Master Agreement; one legacy that is certain to remain is the introduction of a sunset clause, of as yet an indeterminate period, to the non-defaulting parties' right to make a choice as to what to do following the counterparty's default. The second and third court cases reviewed in this article—actually back-to-back cases—consisted of parallel court actions where the same facts were litigated in London and New York, and the courts reached conflicting decisions. The cases graphically illustrate the effect of legal fragmentation because not only do London and New York share the same common-law background, but both are keenly aware of the need to avoid conflicting court decisions. The New York decision was handed down later than its London counterpart, and the New York judge called for a status conference for resolving the clash between the two decisions. This aspect of dialogue between and among key jurisdictions is a feature of lawmaking that has gained momentum and scope in recent years and has facilitated global financial transactions. Such dialogue occurs horizontally and involves the courts, industry and regulators within the same jurisdiction; it also takes place vertically, progressing from domestic, regional to supranational institutions.[8] The institutional authority of the status conference called for by the judge in

6. In re Lehman Brothers Holdings, Inc., Case No. 08-13555 et seq. (JMP) (jointly administered) (2010).

7. The cases include: LBSF and LBHI v. AIG CDS; The Board of Education of the City of Chicago v. LBSF and LBHI; and Lehman Brothers Commercial Corporation v Norton Gold Fields Ltd. *See* Andrea Pincus, "The Metavante Ruling—In a Case of First Impression, US Bankruptcy Court Limits ISDA Counterparty Rights Upon a Bankruptcy Event of Default" Energy Trade and Commodities Alert, Alert 09-303 (Dec. 3, 2009).

8. *See* Joanna Benjamin & David Rouch, *supra* note 4; Julia Black & David Rouch, *The Development of the Global Markets as Rule-makers: Engagement and Legitimacy*, 2 L. & FIN. MARKETS REV. 218 (2008).

the US *Lehman Brothers* case, however, is not clear, and the enforceability of any decisions would be problematic.

BUSINESS AND LEGAL BACKGROUND—GLOBALIZED FINANCIAL INDUSTRY CONGLOMERATES OPERATING IN A FRAGMENTED LEGAL LANDSCAPE

The global financial crisis of 2007-09 was a graphic reminder of the interconnectedness among world economies that resulted from the steady march of globalisation. It was also a reminder of the ever-present threat of financial distress and insolvency of institutions, even those that appear invincible. A most visible aspect of globalisation and recent global economic prosperity is the global reach of business conglomerates and none more so than the large banks. Banks and other multinational businesses operate through complex corporate groups that are interlinked managerially, operationally, and financially such that a problem that occurs in one member of the group in one jurisdiction may have a global reach. One such bank was Lehman Brothers, reputed to have been the fourth largest US investment bank before its collapse[9] and the largest bankruptcy in history, and whose demise is generally thought to have triggered the most widespread financial crisis since the Great Depression. Some spectacular litigation has already resulted from the sequential filing for bankruptcy by Lehman Brothers Holdings International, Inc., the parent company, and Lehman Brothers Special Financing, the subsidiary, and, on occasion, the issue has been whether the borrower for bankruptcy purposes was the corporate group, the parent company or the individual subsidiary.[10] The demise of Lehman Brothers illustrated the breakneck speed that events can take when trouble brews in some quarter and the multi-jurisdictional nature of litigation arising from one large multinational company. It also illustrated that a distressed company or defaulter need not be poor; indeed the company's overall financial position could be bad while at the same time some of its contracts or subsidiaries are "in the money."

Business Features of Cross-Border Transactions

There are a number of business features of cross-border financial transactions that have led to commensurate developments in the law. First, the transactions are huge in size and involve a number of financial institutions. For instance, syndicated loans made to corporate borrowers

---

9. Other recent problematic companies that collapsed or were on the brink of doing so include AIG, Enron, Worldcom and Parmalat.

10. This distinction in part explains the different outcomes in the UK case of *Perpetual* and the US case of *Lehman Brothers*, discussed *infra*.

in leveraged finance deals are structured to appeal to different lenders' or investors' appetites for risk in exchange for a higher risk of loss and will thus be structured in tiers that include senior lenders and subordinated debt, which takes the form of a first lien or mezzanine. This business structure is a recipe for conflict because different types of lenders have different attitudes towards investment. Some take a long-term perspective while others take a short-term perspective. The approach of the two groups to a struggling or defaulting borrower can be quite different, with some lenders prepared to give the borrower some breathing space to trade out of its difficulties, while other lenders would prefer to crystallise a loss and enforce security.

Secondly, the large-sized loans entail large credit risk, and lenders and investors necessarily engage in risk-management products such as credit derivatives and swaps to hedge against the risk of loss. At the same time lenders are managing risk, large corporations are also managing the risks facing them—such as foreign-exchange risk, profit or interest risk, and commodity risk—thus creating a large and vibrant market for derivative products.[11] Thus, a prevalent feature of modern financing is the use of credit default swaps, which are the commonest financial derivatives used to hedge against the risk of loss by transferring the risk to another party. The legal nature of credit default swaps ("CDS") was described in *AON Financial Products, Inc. v Societe Generale*:[12]

> Simply put, a credit default swap is a bilateral financial contract in which a protection buyer makes periodic payments to the protection seller, in return for a contingent payment if a predefined credit event occurs in the reference credit. . . . Often the reference asset that the protection buyer delivers to the protection seller following a credit event is the instrument that is being hedged.

The court went on to clarify CDSs are different from insurance contracts:

> CDS agreements are thus significantly different from insurance contracts. . . . [T]hey "do not, and are not meant to, indemnify the buyer of protection against loss. Rather, CDS contracts allow parties to "hedge" risk by buying and selling risks at different prices and

---

11. While most derivatives are entered into for speculation and arbitrage, some 10% are used for actual hedging. For the whole spectrum of derivatives and their documentation, *see* SIMON FIRTH, DERIVATIVES: LAW AND PRACTICE (London: Sweet & Maxwell, 2010).

12. AON Financial Products, Inc. v. Societe Generale, 476 F.3d 90, 96 (2d Cir. 2007) (citing Eternity Global Master Fund Ltd. v. Morgan Guar. Trust Co. of N.Y., 375 F.3d 168, 172 (2d Cir. 2004)).

> with varying degrees of correlation." ... The terms of each credit swap agreement independently define the risk being transferred.[13]

Credit risk mitigation techniques are part and parcel of modern investment portfolio management but are also frequently required by the credit-rating agencies that have become a significant feature of the larger financial transactions. Where a corporate group is involved, one technique is the provision of credit enhancement by another member of the group, say the parent company, which guarantees the obligations of its subsidiary. Such an arrangement gives the creditor two entities to look to for the fulfilment of its obligation—the principal debtor and the credit support provider (guarantor), and, by the terms of most financial contracts, the default of the guarantor constitutes the default of the principal debtor as well. Credit-risk mitigation was an important part of the factual matrix in the Lehman Brothers litigation discussed further below.

Thirdly, many loans are actually held by institutional investors and other financial institutions rather than commercial banks, as was traditionally the case. Such providers of funds include sovereign wealth funds, private equity, hedge funds, mutual funds, pension funds, and insurance companies. The non-bank lenders get involved in the loan either at the outset, i.e. primary syndication level, or at the secondary level, where they acquire loan interests by way of purchase from the original lenders. Non-bank lenders have had a tremendous impact on loan markets. First, they see their involvement in a loan as an investment that should produce viable returns on its own merit when compared to other investment instruments, and they will dispose of the loan for alternative forms of investment if the outlay on the loan is not profitable. Non-bank lenders are thus unlike commercial banks that are relationship-driven and tend to hold on to the loan as a market leader in the hope of ancillary services. To be able to compare the loan with other assets, such investors demand asset liquidity, transparent pricing and efficient trading procedures.

The desire of institutional investors to acquire loans and the desire of banks to sell loans have resulted in many loans being sold off to international investors through Collateralised Debt Obligations

13. AON Financial Products, Inc. v. Societe Generale, 476 F.3d 90, 96 (2d Cir. 2007). *See also* Schuyler K Henderson, *Regulation of Credit Derivatives: to What Effect and for Whose Benefit?* 8 J. INT'L BANKING & FIN. L. 480 (2009) (discussing further differences between credit default swaps and insurance contracts include 'pure loss rather than speculative loss, different common law/legal standards (absence of subrogation, standards on full disclosure or absence thereof, and different markets and methods of contracting (including MTM [mark-to-market] valuation and regular transfers/novations of CDSs')).

("CDOs").[14] The loans therefore end up as part of a different transaction. Case law resulting from the global financial crisis has provided judicial descriptions of the key features of these complex transactions that are an established feature of the modern financial landscape.

CDOs are

> a financial structure at the centre of which a special purpose vehicle ("SPV") issues tranches of debt securities, the performance of which is linked to a portfolio of assets. The SPV may either hold the underlying assets (a "cash CDO") or take exposure to assets such as corporate bonds or asset-backed securities via a credit default swap with a financial counterparty (a "synthetic CDO"). The performance of CDOs is linked or "referenced" to the pool of underlying bonds or securities, the "Reference Pool."
>
> In the case of a synthetic CDO the issuer may (as in the present case) invest the proceeds of issue of the CDOs in a portfolio of high quality, typically AAA-rated assets ("collateral"); those collateral assets are used to generate income to make coupon (interest) payments on the CDOs and, in the case of a default of any of the Reference Pool to which the SPV is exposed, to pay the financial counterparty the loss due under the credit default swap. On each occasion on which one of the assets in the Reference Pool defaults or is subject to some other "credit event" (such as a downgrading of its credit rating), then a payment becomes due from the SPV to the financial institution under the credit default swap. At the same time, the principal and interest due from the SPV to the CDO noteholder is correspondingly reduced. The usual practice is for CDO notes to be issued in different classes, whereby the losses are allocated sequentially commencing with the most "junior" tranche of notes until the original principal amount of such class of notes are written down to zero, and then losses are allocated to the next "higher" tranche of notes, until the entire capital structure is exhausted or the maturity date of the CDO notes occurs. As a consequence junior notes suffer as a result of earlier Reference Pool defaults/other credit events and the less risky "senior" tranches suffer loss only after the underlying classes of CDO notes have been reduced to zero principal value.
>
> A common feature of actively managed CDOs is that one of the parties to the transaction has the right to alter the composition of the Reference Pool. Such a right potentially increases the risk for the holder of the CDO note, particularly if the party with the right to alter

14. This was the cause of action in UBS Securities LLC v. HSH Nordbank AG [2009] EWCA Civ 585.

> the composition of the Reference Pool has an economic interest in the transaction, as in the present case.[15]

Finally, the larger financial transactions are typically arranged on the basis of standardised documents that are recommended by leading industry associations such as ISDA (International Swaps and Derivatives Association, Inc), LMA (Loan Markets Association), LSTA (Loan Syndications and Trading Association) and the ICMA (International Capital Markets Association). These associations consult widely with industry practitioners and regulators, and they work in close collaboration with the leading law firms in the world (many of whom are members of the associations). As a result, any decision on a large transaction will be watched closely and has the potential for global impact because many other transactions are based on the same template of documents.

The usual approach taken by English courts (and this is also true for most courts in the leading financial centres) is to enforce the words of the contract negotiated by the parties.[16] The courts hold that risk allocation should be left to the parties, who are typically sophisticated (the clients are sophisticated investors, borrowers or counterparties, and the financial products are sophisticated) and are advised by competent and experienced legal counsel. The courts' role in this regard is usually limited to the application of the words of the contract[17] since consumer issues do not intrude in this area.

FINANCIAL TRANSACTIONS IN THE COURTS

The courts' usual contribution to financial law is the interpretation and application of the law such that the law develops in the same direction as industry practices. From time to time, though, there are occasional divergences between the court decisions and some

---

15. UBS AG v. HSH Nordbank AG [2009] EWCA Div 585 at [10]-[12].

16. Granted there are some differences of approach between those that adopt a literal interpretation of the contract and those that are more willing to take into account the context or commercial background. Recent English cases that have taken into account the commercial object of the contract in the interpretation of contracts include Re Sigma Finance Corp [2009] UKSC 2, Re Golden Key Ltd [2009] EWCA Civ 636, Cattles plc v. Welcome Financial Services Ltd. [2009] EWHC 3027 (Ch), and ING Bank NV v. Ros Roca SA [2010] EWHC 50 (Comm). Those that adopted the literary approach include Mills v. HSBC Trustee (CI) Ltd. [2009] EWHC 3377 (Ch) and Chartbrook Ltd. v. Persimmon Homes Ltd. [2009] UKHL 38.

17. *See e.g.*, JP Morgan Chase v. Springwell [2008] EWHC 1186; Peekay Intermark Ltd v. Australia and New Zealand Banking Group Ltd. [2006] EWCA 386; IFE Fund SA v. Goldman Sachs International [2007] EWCA Civ 811; Raiffeisen Zentralbank Osterreich AG v. Royal Bank of Scotland 2010 EWHC 1392 (Comm); British Energy Power and Trading Ltd v. Credit Suisse [2008] EWCA Civ 53 (CA).

perceptions in commercial quarters. A court decision that is out of alignment with commercial perceptions is usually followed by debate and refinement of the standard form documentation or corrective legislative action and in that way contributes to the development of the law. One such decision involved the Metavante corporation and Lehman Brothers.

Metavante[18]

The facts of this case took place between two US business entities, and the transaction was governed by New York law. The case potentially has global implications, however, because it pitted US bankruptcy law and policy against standard terms in the ISDA Master Agreement, which is a form used globally. The *Metavante* decision concerned straightforward interest rate swap transactions that were entered into in 2007 between the Metavante corporation and Lehman Brothers Special Financing, Inc. ("LBSF") on the basis of the 1992 ISDA Master Agreement. Lehman Brothers Holdings, Inc. (LBHI) was the credit support provider and guaranteed the obligations of LBSF. Under the swap agreement, Metavante was the fixed-rate payer and was required to make quarterly payments based on a fixed interest rate, while LBSF, as the floating rate payer, was required to make quarterly payments based on a floating rate. The payments were netted, and the net payer was required to pay the difference on a scheduled payment date. Under the contract the events of default included the bankruptcy of a counterparty or its credit-support provider;[19] the right, but not the obligation, of the non-defaulting party to designate early termination upon the occurrence of an event of default;[20] and the right to withhold performance upon the occurrence of an event of default that was continuing.[21]

LBHI filed for bankruptcy protection under Chapter 11 of the US Bankruptcy Code on September 15, 2008, followed three weeks later by LBSF's bankruptcy filing on October 3, 2008. Under the ISDA Master Agreement,[22] each bankruptcy filing was a separate and independent event of default giving rise to Metavante's right to designate an early termination date, and the trigger of the right to withhold performance as

18. In re Lehman Brothers Holdings, Inc., Case No. 08-13555 et seq. (JMP) (jointly administered). The narrative of facts in the text draws heavily from Andrea Pincus, *supra* note 7.

19. *See* ISDA Master Agreement §5(a)(viii).

20. *See id.* § 6(a).

21. *See id.* § 2(a)(iii)

22. *See id.* § 5(a)(vii).

long as an event of default was continuing.[23] It was common ground that an early termination would have yielded a multi-million dollar payment to LBSF and that the scheduled payments were substantially in favour of LBSF. Metavante did not designate an early termination of the agreement and instead chose to withhold payment under the individual transactions that remained outstanding.

In May 2009, Lehman Brothers (the debtor and defaulting party) moved to compel performance by Metavante (the non-defaulting party) and claimed payment of all past-due amounts plus default interest. Lehman Brothers essentially based its arguments on US bankruptcy law and policy. First, it argued that while the Bankruptcy Code respected the contractual rights of the non-defaulting party to terminate, accelerate or liquidate its positions in derivatives contracts and net payments, such rights inhered only if the contract was terminated. Second, it was against the legislative intent of the Bankruptcy Code for Metavante to rely on section 2(a)(iii) of the ISDA Master Agreement and choose to keep the contract on foot rather than to promptly terminate it after default. The legislative intention favoured prompt termination so as to permit markets to continue functioning in the direct aftermath of a major player's collapse. Third, section 2(a)(iii) was an unenforceable *ipso facto* clause in contravention of the Bankruptcy Code.[24] It was claimed that "Metavante effectively modified the parties' contract rights by permitting indefinite suspension of performance obligations only because of the financial condition of the debtors and commencement of the bankruptcy cases."

Metavante, on the other hand, relied on the ISDA Master Agreement and argued that it had the right, but not the obligation, to terminate outstanding transactions and that there was no time limit for making the choice. Secondly, it argued that section 2(a)(iii) "expressly permitted the non-defaulting party to suspend its performance while an event of default was continuing, again with no contractual time limit and no exception for a bankruptcy event of default." Thirdly, Metavante argued that "the US Bankruptcy Code . . . expressly excepts from the *ipso facto* clause prohibition positions under a swap or master netting agreement, and does so without imposing any statutory time limit." The key provisions governing payment and delivery of obligations which the court had to apply were the following.

Section 2(a)(i) of the ISDA Master Agreement states:

23. *See id.* § 2(a)(iii).
24. *See* 11 U.S.C. § 365(e) (2005).

> Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.

Section 2(a)(iii) of the ISDA Master Agreement states:

> 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, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement.

In a bench ruling,[25] the court held in favour of the defaulting party (Lehman Brothers) and against the non-defaulting party (Metavante). In a nutshell, the court decided that under United States law a non-defaulting party must make a choice to terminate or not terminate the contract, and the party has a limited time within which to make that choice. But this does not tally with the express wording of the ISDA Master Agreement. The court expressly limited the "enforceability of section 2(a)(iii) of the ISDA Master Agreement and the scope of the US Bankruptcy Code protections for non-defaulting parties to derivative contracts." The court ruled that, first, each of the respective bankruptcy filings of LBHI and LBSF constituted a separate event of default that triggered Metavante's right to terminate the transaction. Secondly, the safe-harbour provisions of the US Bankruptcy Code apply only to protect a non-defaulting swap counterparty's contractual rights solely to liquidate, terminate or accelerate derivative contracts upon the bankruptcy of a counterparty or to offset or net out any termination values or payment amounts or foreclose on collateral. The provisions do not apply where the non-defaulting party fails to terminate, liquidate or accelerate the swap, and they "do not permit the withholding of performance under a swap if the swap is not terminated." The court explained that

> the exceptions to the unenforceability of an *ipso facto* clause—in this case for executory contracts that are swaps—do not extend to the contractual right to withhold performance under section 2(a)(iii) where such indefinite delay of performance is triggered because of the financial condition of the debtors. Suspension of payments, as

25. There are reports that the court had previously encouraged the litigants to settle their dispute, and the judge was "visibly displeased" by the lack of effort on the part of Metavante to settle the dispute: *see* Pincus, *supra* note 7.

opposed to termination, thus amounts to a prohibited modification of the parties' rights and obligations under the contract.

Lastly, even though there was no contractual or statutory time limit on the right to terminate derivative transactions because of a bankruptcy default, Metavante's window of opportunity to act promptly under the safe-harbour provisions had passed, and it waived its right to terminate the transactions when it waited more than eleven months after the debtor's bankruptcy filings before seeking to terminate. The court therefore ordered Metavante to pay the amounts withheld together with default interest in spite of the ISDA section 2(a)(iii), which permitted such withholding in the face of the continuing default by LBSF and LBHI.

There were a couple of unique facts in the *Metavante* decision that might have swayed the court's decision against the non-defaulting party. First, Metavante chose to maximise its own benefits from the bankruptcy of Lehman Brothers by failing to net payments, which would have resulted in Metavante's making substantial payments to Lehman Brothers. Secondly, Metavante chose to ride out the crisis by delaying its decision for some eleven months when the usual commercial expectation was to do it promptly. In this light, the court's decision was understandable because the court said, in essence, that there was a limit on the extent to which a non-defaulting party could shield behind the literal reading of the ISDA provisions and other transaction documents.

One can pick quite a few areas where the court's reasoning is not entirely satisfactory.[26] First, for purposes of applying the *ipso facto* clause, the decision did not make a distinction between the default of the credit support provider (LBHI) and that of the debtor (LBSF), even though there was a time gap between the two. If that distinction were made, one could cogently argue that the trigger for Metavante's right to modify contractual rights under ISDA section 2(a)(iii) occurred on the earlier bankruptcy and not on the onset of the debtor's bankruptcy.[27] Secondly, the court did not give clear guidance on how long was too long to wait before a non-defaulting party lost its right to terminate transactions or net payments, or before it would be deemed to have waived its right to terminate. Even though a specific time limit would not have been helpful in light of the variety and complexity of the transactions for which the ISDA Master Agreement is used, the court would have been more helpful had it created a general "reasonable time"

26. *See* Pincus, *supra* note 7.

27. It was only in *Lehman Bros. v. BNY* that the court clarified that the Lehman Brothers companies were to be seen as one corporate family. In *Metavante* the court saw them as different corporations.

standard or held that there was an implied term in every such contract that the non-defaulting party would act within a reasonable time.[28] While such a standard is fluid, it is helpful enough in common-law jurisdictions where courts and parties know how to apply it. It would require the parties and the courts to weigh the relevant factors in each particular transaction such as the volume, complexity, and interconnectedness of the transactions covered by the ISDA Master Agreement; the challenges in obtaining replacement trades from qualified counterparties; and the difficulty of the issues involved in restructuring an entire portfolio of an insolvent counterparty.[29]

Arguably, the most noteworthy and controversial aspect of *Metavante*—one with potentially a global reach—was the limit on the enforceability of Section 2(a)(iii) of the ISDA Master Agreement. In refusing to enforce the section in accordance with its terms, the court surprised prevailing orthodoxy, and initial reaction in the media was to say that it was unsafe to do business in the United States. A literal reading of the section appears to suggest that it is open-ended and that it entitles the non-defaulting party to do nothing other than terminate the transactions and crystallise the obligation. The *Metavante* court ruled that in the circumstances of the case, the section did not mean what it said on its face and that the non-defaulting party did not have the choice simply to do nothing indefinitely. The non-defaulting party should have fairly promptly elected to terminate the transactions; having failed to do so, the non-defaulting party was not permitted to terminate or suspend payments until the debtor elected to accept or reject the swap in question. As has been observed, *Metavante* revealed a loophole in the section in that the non-defaulting party can withhold payments indefinitely. The issue is whether the loophole was closed the right way when the court ruled that the section was unenforceable.[30]

Comparing *Metavante* with other global authorities, *Metavante* conflicts with *Enron Australia v. TXU Electricity*[31] on the right to suspend payments under section 2(a)(iii) of the ISDA Master Agreement.[32] *Enron Australia* is generally taken to confirm the non-defaulting party's right to withhold payments and the general

28. For an argument in favour of an implied term for acting within a reasonable time, *see* Mark Daley, *Defining the Limits of s2(a)(iii)—Resolving the Section's Indefinite Applicability*, 24(11) BUTTERWORTHS J. INT'L BANKING & FIN. L 647 (2009).

29. *See* Pincus, *supra* note 7.

30. *See* Daley, *supra* note 28; *see* Wilbur F. Forster, Jr., et al., *Court Explores Termination Rights Under Bankruptcy Code Section 560*, PRATT'S J. BANKR. L. 505 (2009).

31. Enron Austl. v. TXU Elec. [2003] NSWSC 1169, *affirmed as* Sims v. TXU Elec. Ltd. [2005] NSWCA 12.

32. *See* Pincus, *supra* note 7, at 5.

enforceability of the section. The court also upheld the contractual right not to designate an early termination to the contract.[33] There are some crucial factual differences between the two cases, though. In *Enron Australia*, the parties agreed and the court assumed that the ISDA provisions meant what they said—especially that Section 2(a)(iii) was enforceable and that the section did not operate indefinitely.[34] There were also, however, factors that make a case for similar decisions between the two cases. In *Enron Australia*, the non-defaulting party was also a net payer and therefore had a similar economic interest to that in *Metavante* not to terminate the arrangement. In fact, the period for suspending payment was also much longer, stretching from 2001 to 2005, and still it was assumed all around that the section meant what it said.

Metavante is also hard to reconcile with the English case of *Marine Trade SA v. Pioneer Freight Futures Co. Ltd.*,[35] where the enforceability of Section 2(a)(iii) was not in issue and was assumed. In *Marine Trade* the plaintiff relied on the section for purposes of netting payments and recovery by way of restitution for payments made under protest. Like in *Metavante*, the net payments were in favour of the defaulting party, and it was argued that it would be absurd and commercially unreasonable for the defaulting party to keep making gross payments when in fact the defaulting party was owed money after netting all the obligations between the parties. Yet the court observed that this "commercial sense" was not sufficient to gainsay the clear meaning of the contract when the contract was not so unreasonable commercially that the court should override it.[36] The court noted that the non-defaulting party was perfectly entitled not to elect for early termination and at the same time to insist on gross payment by the defaulting party without any time limit.

On this account, the *Metavante* decision is in the minority.[37] But this does not necessarily mean that *Metavante* is wrong. On balance, the decision was too drastic to declare the contract unenforceable. On the other hand, commentators agree it would not make commercial sense for the non-defaulting party's right to withhold payment to be available

33. *See also* Colin Riegels and Russell Willings, *Metavante and ISDA Master Agreement: BVI Perspective*, (Oct. 28, 2009) INT'L L. OFFICE, http://www.internationallawoffice.com/newsletters/detail.aspx?g=880dced0-2944-4fde-ad0d-8b9feed78a35.

34. *See also* Daley, *supra* note 28.

35. Marine Trade SA v. Pioneer Freight Futures Co. Ltd. BVI [2009] EWHC 2656 (Comm).

36. The court applied the dictum in *Schuler v Wickman Mach.Tools* [1974] A.C. 235, 251.

37. *See also* Russell Willings, Derivatives and Insolvency: a British Virgin Islands Perspective on the Metavante Decision and the ISDA Master Agreement 3(1) CORP. RESCUE & INSOLVENCY J. 18 (2010).

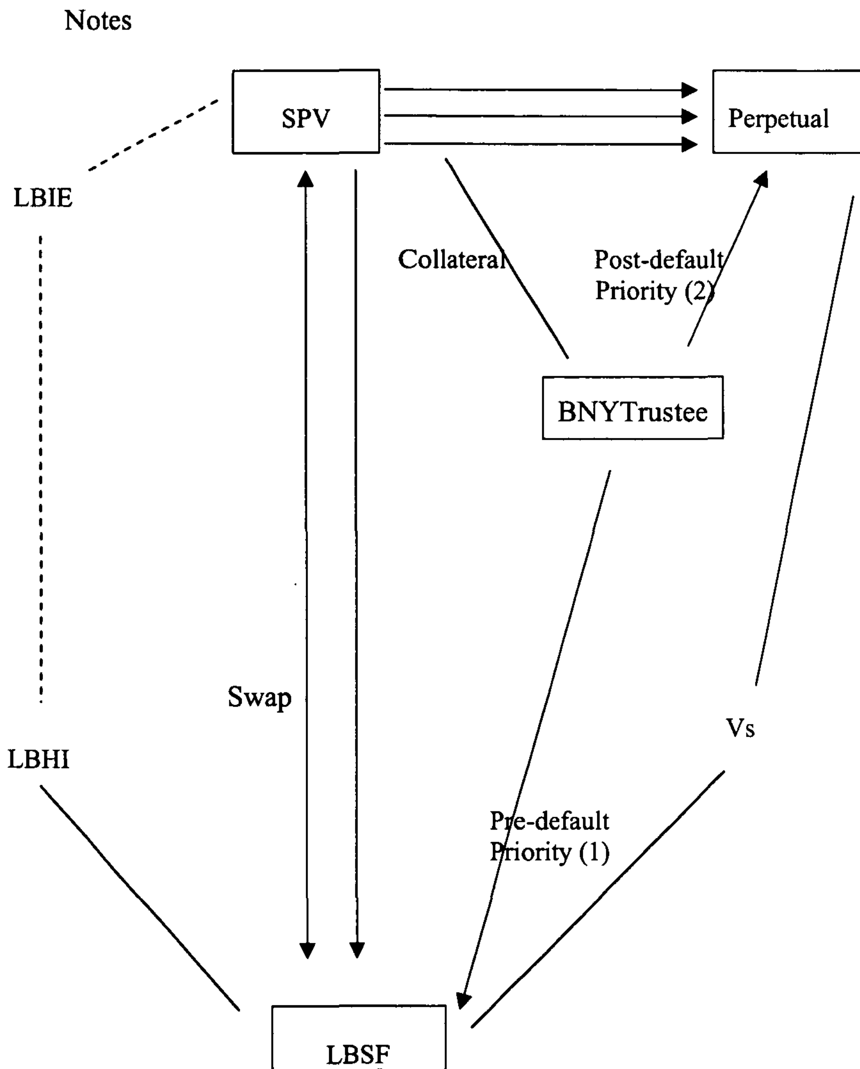
indefinitely.[38] There needs to be a limit on how long a non-defaulting party can withhold payments, and the *Metavante* decision did not clarify how long is too long. In the instant case the court thought that eleven months was too long, and yet in *Enron Australia* the parties and the court did not see any difficulty with four years. Clearly, a rigid timetable is not the answer, and the solution might lie in the adoption of the concept of "reasonable time," the determination of which would depend on the particular transaction under consideration.[39]

Lehman Brothers—*UK Litigation*

The next two cases were based on the same facts and are summarised by the following diagram.

38. *See* Schuyler Henderson, *Master Agreements, Bridges, and Delays in Enforcement, Part 3*, 20(1) BUTTERWORTHS J. INT'L BANKING & FIN. L. 18 (2005).

39. The application of the "reasonable time" concept would be similar to that found in the Uniform Customs and Practices for Documentary Credits. *See* Daley, *supra* note 28.



The Perpetual Trustees/Lehman Brothers Litigation

In *Perpetual Trustee Co. Ltd. v. BNY Corporate Trustee Services Ltd.*,[40] an investor sued the collateral trustee to enforce the contract terms that gave the investor priority to the collateral following the default of the swap counterparty. The Lehman Brothers companies (Lehman Brothers International Europe or "LBIE") had set up a special purpose vehicle ("SPV") that issued notes to investors in the form of synthetic collateralised debt obligations. The subscription money obtained from

40. Perpetual Tr. Co. Ltd. v. BNY Corp. Tr. Serv. [2009] EWCA (Civ)1160.

investors was used by the SPV to purchase the collateral for the notes. The SPV in turn entered into a credit default swap with Lehman Brothers Special Financing ("LBSF") (the swap counterparty) under which the swap counterparty paid regular amounts to the SPV so that the SPV could service the payments to the noteholders; in exchange, the swap counterparty was rewarded with sums equal to the yield on the collateral. The collateral was charged by the SPV in favour of a trust company to secure the SPV's obligations to its creditors, who included the noteholders and the swap counterparty. The trust deed provided that the rights of the swap counterparty to payments and the collateral would ordinarily have priority over payments to the noteholders, but that the priority would change in favour of the noteholders on the occurrence of an insolvency event by the swap counterparty or credit-support provider.[41] The swap agreement was subject to the ISDA Master Agreement, and all the transactions were governed by English law.

On September 15, 2008, LBHI filed for Chapter 11 bankruptcy protection in the United States. That act constituted an event of default under the swap documentation because LBHI was designated as a credit support provider of LBSF. On October 3, 2008, LBSF also filed for Chapter 11 bankruptcy protection, which also constituted an event of default and triggered a priority switch from the swap counterparty to the noteholders as to entitlement to collateral. The noteholders were not paid, and they gave notice to the trustee to terminate their arrangement and required the trustee to enforce the security. The swap counterparty (LBSF) challenged the noteholders' claim to priority, arguing that it would fall foul of the anti-deprivation rule.[42] The trial judge held[43] that the disadvantage suffered by LBSF did not come within the rule and that the provisions changing priority to collateral were operated before LBSF filed for bankruptcy protection. The Court of Appeal unanimously dismissed LBSF's appeal by first asking if there had been a deprivation of property and by second asking about the timing of the deprivation. It held that the "flip" of priority from the swap counterparty to the

41. This is the so-called "waterfall flip."

42. While the scope and preciseness of the anti-deprivation rule is subject to debate, the courts agree that the modern rule is based on public policy and says that one cannot contract out of the insolvency regime. *See* Perpetual, [2009] EWCA (Civ) 1160, *citing* British Eagle Int'l Air Lines v. CompagnieNationale Air France [1975] 1 WLR 758, *per* Cross LJ (HL); Carreras Rothmans Ltd. v. Freeman Mathews Treasure Ltd. [1985] 1 Ch 207, *per* Gibson J; and Int'l Air Trans.Ass'n v. .Ansett Austl. [2008] BPIR 57 (HC). The rule was stated by Cotton LJ in *Ex parte Jay* that "there cannot be a valid contract that a man's property shall remain his until his bankruptcy, and on the happening of that event shall go over to someone else, and be taken away from his creditors." *Ex parte Jay;* In re Harrison (1880) 14 Ch D 19 at 26, *see also* Money Markets Int'l Stockbrokers v. London Stock Exch.[2002] 1 W.L.R. 1150 (Ch D).

43. *See* Perpetual, EWCA (Civ)1160.

noteholders was not a divesture or transfer of property to the noteholders but merely a change in the order of priorities in which rights were to be exercised in relation to the proceeds of the sale of collateral in the event of default. Furthermore, the court reasoned that it was an agreed feature of the contract documents from inception that the priority right enjoyed by LBSF over collateral was contingent on there being no event of default; the priority right was therefore lost in favour of the noteholders on the occurrence of default. In addition, the court noted that the anti-deprivation rule might not apply where, as in the instant case, the person for whose benefit the deprivation took effect could show that the asset, or the insolvent's interest in the asset, over which the deprivation took effect was obtained by his or her own money.[44] Lord Justice Patten took the simple view that the "flip" was an original feature of the contract and could not possibly be seen as a deprivation of property at the onset of the counterparty's bankruptcy.[45] Secondly, the court held that the switch or "flip" from counterparty to noteholder priority did not violate the anti-deprivation rule because it occurred before, not on or after, liquidation since the alteration of priority was triggered when LBHI filed for Chapter 11 bankruptcy, which was some eighteen days earlier than when LBSF (the credit support provider) filed for bankruptcy under Chapter 11.[46] A deprivation did not fall within the scope of the rule if it occurred before winding up or its equivalent.

As a matter of policy, English courts emphasise the principle of party autonomy. In the High Court, the Chancellor observed that courts should enforce the parties' agreement rather than enforce the anti-deprivation rule on them. In the Court of Appeal, Lord Neuberger M.R. made clear that that in "complex and sophisticated contractual arrangements the parties should be expected to know what they were doing, and the courts should be slow to take away their right to freely contract on terms as they see fit."[47] As the Master of Rolls pointed out:

> It is important that, so far as possible, judicial decisions in the insolvency field ensure that the law is clear and consistent. That has always been true, but the need for consistency and clarity is all the greater now that commercial contracts are becoming increasingly complex both in their underlying nature and in their detailed

44. *See* Whitmore v. Mason (1861) 70 Eng. Rep. 1031.

45. *See* Perpetual, EWCA (Civ) at 1160.

46. The court and litigants agreed that the filing of Chapter 11 bankruptcy was equivalent to making a winding-up order under English law.

47. *See* Christopher Harlowe, *Perpetual Trustee Co Ltd v BNY Corporate Trustee Services Ltd—the anti-deprivation principle—whose rights are they anyway?* 21(3) ENTM'T L. REV. 114, 114-115 (2010). It is important to note that the anti-deprivation principle was only reigned in and not thrown out altogether.

> provisions, as is well demonstrated by the contracts in the instant cases. . . . It is also desirable that, if possible, the courts give effect to contractual terms which the parties have agreed. Indeed, there is a particularly strong case for party autonomy in cases of complex financial instruments . . . and in arrangements involving large corporate groups . . .; in such cases, the parties are likely to have been commercially sophisticated and expertly advised.[48]

Lehman Brothers—*US Litigation*

In *In re Lehman Brothers Holdings Inc. v. BNY Corporate Trustee Services Ltd.*,[49] the facts were exactly the same as those in the English counterpart of this case (*Perpetual Trustee Co Ltd v BNY Trustee Services Ltd*, above) and the swap counterparty, i.e., the debtor, initiated court action in the United States to compel the trustee to disregard the contract documents. The swap counterparty argued that the contractual provisions which required the modification of the scheme for payment priority were unenforceable *ipso facto* clauses under the US Bankruptcy code because they inappropriately modified the debtor's interest in a contract solely because of a bankruptcy filing.[50] The debtor also argued that any attempt to modify the payment priority would violate the automatic-stay provisions of the Bankruptcy Code[51] because it would improperly mark an exercise of control over the property of the debtor's estate. Finally it argued that so-called safe-harbour provisions of the Bankruptcy Code did not protect the purported modification of payment priority. BNY defended by arguing that the documents were governed by English law and were to be construed in accordance with English law and, under the principles of *res judicata* and comity therefore, the New York court should defer to the determination of the issues by the English courts. BNY also argued that LBSF could not use its status as a bankruptcy debtor to garner greater rights with respect to the collateral than it possessed before the bankruptcy petition. Furthermore, BNY argued that the payment modifications at issue were the agreed upon mechanisms by which the parties' transactions were to be liquidated and fell within the safe harbour provisions of the Bankruptcy Code.

The Bankruptcy Court began by justifying its application of United States law at the expense of English law even though the latter had been

48. *Per* Lord Neuberger of Abbotsbury MR in Perpetual, EWCA (Civ) 1160.

49. *See* In re Lehman Bros. Holdings, Inc.v. BNY Corp. Tr. Serv. Ltd., 422 B.R 407 (Bankr. S.D.N.Y. 2010).

50. Reliance was put on US Bankruptcy Code, 11 U.S.C. §§ 365(e)(1) and 541(c)(B) (2005).

51. *See* 11 U.S.C. § 362(a)(3) (2005).

explicitly chosen by the parties as the governing law of the contract documents. The court noted that it was not obliged to recognise a judgment rendered by a foreign court but that it could give *res judicata* effect on the basis of comity. It then observed that the English courts had not taken account of the principles of US bankruptcy law in the earlier proceedings that the trustee wanted enforced. It held that as a general matter "courts will not extend comity to foreign proceedings when doing so would be contrary to policies or prejudicial to the interests of the United States."[52] While recognising that the application of the Bankruptcy Code would yield an outcome directly at odds with the judgment of the English courts, the court articulated the guiding policy:

> Despite the resulting cross-border conflict, the United States has a strong interest in having a United States bankruptcy court resolve issues of bankruptcy law, particularly in a circumstance such as this where the relevant provisions of the Bankruptcy Code provide greater protections than are available under applicable provisions of foreign law.[53]

The court therefore decided not to give "preclusive effect" to the English judgments and proceeded to apply the provisions of the Bankruptcy Code. The bankruptcy court reached different factual and legal conclusions than the English court and applied different law. Key among the differences were these: First, the court held that the priority accorded by the transaction documents to LBSF was a valuable property interest that was entitled to protection as part of the bankruptcy estate. The contract documents that changed priority from LBSF to the noteholders was a modification of that valuable right.[54] Second, the court viewed the Lehman Brothers holding company and the multiple subsidiaries within the corporate group as one integrated enterprise such that the first filing for bankruptcy on September 15 by LBHI was the event that precipitated subsequent related events. The court then noted that the Bankruptcy Code's policy against *ipso facto* clauses prohibits the modification of a debtor's right solely because of an agreement conditioned upon the commencement of a *case* under the Bankruptcy Code[55] and was not limited to the commencement of a case *by or against the debtor*.[56] In the instant litigation, "a case" was commenced by a related entity when LBHI, the corporate parent and credit-support provider, filed for

52. Lehman Bros. Special Fin. Inc. v. BNY Corporate Tr. Servs. (In re Lehman Bros. Holdings Inc.), 422 B.R. 407, 417 (Bankr. S.D.N.Y. 2010).

53. *Id.*

54. In this regard US law, which requires "modification," is different from UK law, which requires "deprivation."

55. 11 U.S.C. §§ 356(e)(1) and 541(c)(1)(B) (2005).

56. Emphasis in original text.

bankruptcy. The court therefore held that the transaction documents which sought to modify the right to priority of collateral (the "flip") after the first filing constituted an unenforceable *ipso facto* clause. Similarly, such provisions violated the automatic stay, which was triggered on the filing of the bankruptcy petition, because they sought to deprive the debtor and its creditors of valuable property.

The bankruptcy court's decision stands as the law of the United States.[57] However, there are some internal weaknesses. First, disregard for the choice-of-law provisions and the reasons given for doing so are not convincing. Commercial parties of the level of sophistication that was involved in the Lehman Brothers litigation give careful consideration to choice-of-law and choice-of-jurisdiction matters and address the prospect of insolvency when they make their choice. The very purpose of choosing a particular well known system, such as English law, is to avoid the surprise that may be sprung upon parties by other systems of law, particularly those they know and deliberately avoid, such as the law of New York. The judge seemed to appreciate that the law he applied was different than what the parties envisaged when they entered into contract. He said:

> [T]he English Courts have been most gracious in allowing room for this Court to express itself independently on matters of importance to the administration of the LBHI and LBSF bankruptcy cases. In applying the Bankruptcy Code to these facts the Court recognizes that it is interpreting applicable law in a manner that will yield an outcome directly at odds with the judgment of the English Courts.

Secondly, the bankruptcy court based itself exclusively on US policy in a situation when another jurisdiction was clearly more relevant—the assets that were the subject of contention were located in England.[58] It is a common occurrence in the practice of large financial transactions that a number of entities from multiple jurisdictions will be involved either as lenders, investors, debtors, guarantors, security trustees, custodians, etc., and the contracting parties allocate their legal risks by choice-of-law provisions. The multi-jurisdictional nature of such transactions forces the parties to decide where they want to litigate and under which system of law; courts should facilitate the transactions by respecting the parties' choices. While there is no doubt that US bankruptcy law and policy are important, the parties contracted to be governed by a different bankruptcy regime—the English law bankruptcy regime—and must be taken to have known that the two regimes have

57. An appeal is pending.

58. *See* Clifford Chance, Client Briefing, *Anti-deprivation: What next for the UK Structured Debt Market?* (2010).

different areas of emphasis. A court that disregards the scheme of allocating risks chosen by industry practitioners fails to appreciate the importance of choice-of-law provisions in structured finance.

Thirdly, the court made no attempt to balance domestic policy with the needs of international business or finance. In commercial contracts involving sophisticated businesses, the parties are normally held to their contracts and cannot be seen to contest the documents they signed. The documents create a contractual estoppel whereby the parties are precluded from denying that the obligations they entered into are binding.[59] This is especially so because a leading player, such as Lehman Brothers, was at the forefront of creating and marketing such financial instruments and could not reasonably say that it did not know what it was doing. The court acknowledged the weakness in its approach in a footnote: "The Court recognizes that there is an element of commercial expectation that underlies the subordination argument. LBSF was instrumental in the development and marketing of the complex financial structures that are now being reviewed from a bankruptcy perspective."[60]

From a broader perspective, the decision declared as unenforceable provisions that are common in structured finance transactions where payments to a swap counterparty are subordinated if the counterparty has defaulted on its obligations. While this might instinctively be seen as a disadvantage to doing business in the United States generally or where the swap counterparty is subject to the US Bankruptcy Code, and while this might at first blush be seen as detracting from the enforceability of subordination provisions generally, it is thought that the impact of the decision might not be widespread and that the decision might be limited to the facts of this case.[61] Furthermore, English law does not have a principle of substantive consolidation that was relied upon by the Bankruptcy Court to treat LBHI and LBSF as the same; the US decision is therefore unlikely to have impact in the UK.[62]

---

59. *See* Peekay Intermark Ltd v. Australia and New Zealand Banking Group Ltd. [2006] EWCA 386; RaiffeisenZentralbankOsterreich AG v. Royal Bank of Scotland [2010] EWHC (Comm) 1392.

60. In re Lehman Bros. Holdings, Inc. v. BNY Corp. Tr. Serv. Ltd., 422 B.R 407, 422 n.9 (Bankr. S.D.N.Y. 2010).

61. *See* Mark Ellenberg and Nick Shiren, *The Enforceability of Structured Finance Subordination Provisions: where to next?* 5 J.I.B.F.L 284 (2010).

62. *See* Clifford Chance, Client Briefing, *Anti-deprivation: What next for the UK Structured Debt Market?* (2010).

CONCLUSION

The global financial crisis of 2007-2009 illustrated graphically that in the era of globalisation business will cross geographical boundaries—and so will litigation. The crisis also provided fertile ground for litigation that has expanded and clarified the boundaries of existing financial law. It was not surprising in this plethora of court cases that some conflicting decisions were reached in different jurisdictions or that long-standing perceptions were tested.

Whatever the merits or demerits of *Metavante*, the decision is the law of the United States and must be taken into account by parties wishing to transact business in that country. The decision potentially has impact beyond the United States because it may influence the views of other courts when they interpret the ISDA Master Agreement section 2(a)(iii). In any event, all parties that enter into transactions that are governed by the ISDA Master Agreement must take the decision into account when they decide whether or not to terminate a transaction following the insolvency of a counterparty.[63] The initial impact was that the decision caused uncertainty in derivatives transactions, especially where US counterparties were involved in transactions that adopted the ISDA Master Agreement. Subsequently the *Metavante* decision was appealed to the United States District Court for the Southern District of New York, and subsequently the Lehman Brothers debtors sought court approval for a settlement deal with Metavante. It has been noted that if the settlement is approved, it would likely forestall a binding precedential judgment by the courts.[64]

English courts have traditionally tried to avoid conflicting decisions with their overseas counterparts, particularly in commercial matters. This was exemplified by Coleman, J. in *Lordsvale Finance Plc v Bank of Zambia*, in the course of considering a provision concerning default interest rate in a loan agreement:

> It would be highly regrettable if the English courts were to refuse to give effect to such prevalent provisions while the courts of New York are prepared to enforce them. For there to be a disparity between the

63. Briefing, Freshfields Bruckhaus Deringer, *US Bankruptcy Court Finds That Payment Conditionality is Unenforceable Under Section 2(a)(iii) of the ISDA Master Agreement* (2009).

64. Ken Coleman, Daniel Guyder & John Williams, Allen & Overy, *Lehman Moves for Bankruptcy Court Approval of Metavante Settlement* (Mar. 2010), *available at* http://www.allenovery.com/AOWEB/Knowledge/Editorial.aspx?contentTypeID=1&itemID=55295&prefLangID=410 (While the settlement would not be binding on other parties, it would provide guidance to those similarly situated in relation to the Lehman debtors).

> law applicable in London and New York on this point would be of great disservice to international banking.[65]

It is sometimes inevitable, however, that the law of one country clashes with the principles of another jurisdiction. A case in point is the earlier insolvency case of *Bank of Credit and Commerce International*,[66] when English law and practice on set-off brushed against the legal principles of other jurisdictions. In that earlier case, English authorities were able to cooperate with other jurisdictions to obtain a satisfactory practical result. Similarly in the US Lehman Brothers case (*In re Lehman Brothers Holdings Inc. v BNY Corporate Trustee Services Ltd*[67]), the court was keenly aware that its application of United States law was in direct conflict with the earlier English decision based on the same facts. The court called for a status conference to sort out the difficulties that confronted the parties in the face of a fragmented legal world. The court said:

> [T]he Court anticipates that the current ruling may be a controversial one, especially due to the resulting conflict with the decisions of the English Courts. . . . This is a situation that calls for the parties, this Court and the English Courts to work in a coordinated and cooperative way to identify means to reconcile the conflicting judgments. The Court directs that the parties attend a status conference to be held on the next available omnibus hearing date in the Debtor's cases for purposes of exploring means to harmonise the decisions of this Court and the English Courts.[68]

The idea of the status conference is appealing, but the power of a court to compel parties to attend or to sanction a non-cooperative party is not so clear.

It bears emphasis that the two conflicting UK and US court decisions that left the trustee caught in the middle of a Trans-Atlantic storm were based on different laws and policy. The anti-deprivation principle in English law focuses on depriving the bankruptcy estate of property while the US *ipso facto* clause focuses on the modification of contractual relationships. The English insolvency regime is largely pro-creditor and ordinarily upholds commercial contracts, while the US bankruptcy court applied a statute that is largely pro-debtor. English law

---

65. Lordsvale Finance plc v. Bank of Zambia [1996] 3 All ER 156; Similar sentiments have been known to exist in the United States as well, *see* AON Financial Products, Inc v. Societe Generale, 476 F.3d 90 (2d Cir. 2007), above.

66. *Bank of Credit and Commerce International SA (No 9)* [1994] 3 All ER 764.

67. In re Lehman Brothers Holdings Inc. v. BNY Corporate Trustee Services Ltd., 422 B.R 407 (Bankr. S.D.N.Y. 2010).

68. *Id.* at 423.

emphasises party autonomy, particularly in complex transactions involving sophisticated parties, while bankruptcy law is pre-eminent in the US. The US court applied the principle of substantive consolidation and considered all the Lehman Brothers companies as one group, while English law did not apply such a concept. The English decision was consistent with the ISDA Master Agreement and was therefore welcomed by most commercial entities (invariably not all of them), while the US decision caused consternation in some commercial quarters because it challenged widely held perceptions. It is thought unlikely that US principles would be applied in the UK.

It is not a novel occurrence that a court decision challenges the wisdom of established law and practice as contained in the documents generated in practice. Examples abound stretching back to the early days of the promissory note and the decisions of Chief Justice Holt[69] to more recent cases involving set off and netting[70] and swaps and derivatives.[71] Legal practitioners understand very well that there is always a risk that a document or provision may be declared unenforceable by the courts. This is exactly what is known as documentation risk, a constituent element of legal risk, which is the mainstay of a lawyer's practice.[72] Practitioners address legal risk in overseas jurisdictions by obtaining legal opinions and routinely advise clients that they cannot be absolutely sure what the courts will do in fact.

A direct clash of court decisions is not necessarily a bad thing. In the history of commercial practice, every setback by the courts has provided an opportunity for further debate and has led to further development of the law and practice.[73] In the short term, legal practitioners may be confused about how to advise clients, but in the long term such clashes lead to debate and further analysis leading to the

---

69. Commercial law folklore teaches that Chief Justice Holt was hostile to the development of promissory notes and had to be overruled by parliament before the instruments were allowed to develop as a very useful facility for trade.

70. *See* British Eagle International Airlines v. Compagnie Nationale Air France [1975] 1 W.L.R. 75.

71. *See* Hazell v. Hammersmith and Fulham LBC [1992] 2 AC 1.

72. *See* ROGER MCCORMICK, LEGAL RISK IN THE FINANCIAL MARKETS (Oxford University Press 2006).

73. More recent examples include the two *Elliott Associates* cases and *Aon. Elliott Assocs*, LP General Docket No 2000/) R/92 (Court of Appeal of Brussels, 8th Chamber, 26 September 2000) reached an unusual interpretation of the pari passu clause and the court action was initiated in Brussels because it was clear that the New York courts would not agree to that interpretation; *see also* Elliott Assoc, LP v. Banco de la Nacion 2000 WL 1449862 (SDNY, 29 September 2000). Following the unusual decision in Brussels, the LMA (industry group in Europe) initiated a discussion group to see the implication of the 'new' interpretation; *see* A MUGASHA, THE LAW OF MULTI-BANK FINANCING: SYNDICATED LOANS AND THE SECONDARY LOAN MARKET 234-234 (Oxford University Press 2007).

development of law and practice. Following significant decisions, standard form contracts are typically updated, new legal opinions issued, and even corrective legislation may follow. It is very clear, therefore, that the courts do influence practice greatly, and any significant decision, however divergent, contributes to the development of the law.[74] It is also clear that industry opinions and commercial practice do influence the law, and in that regard there is a healthy reflexive relationship between the courts and legal practice.

The court decisions discussed in this article illustrate an important aspect of the development of commercial law in the present era. Many financial centres are contributing to the law because of the integration of the global financial market.[75] The majority of the most complex transactions take place in Europe and are particularly centred in London on the one hand, and the United States and particularly in New York on the other hand. There are many nodes in the different geographical regions of the financial market, but the current leadership of the law and transactions is a bi-polar, trans-Atlantic affair that is backed by English law and courts on the one hand, and New York law and courts on the other. In this light, the cooperation between the courts, practitioners and regulators in London and New York on important financial matters such as the interpretation of the ISDA Master Agreement is a service to the global financial industry. This trans-Atlantic cooperation, flagged by chance by the US bankruptcy judge following a curious decision, may be one of the more visible legacies[76] of the Lehman Brothers litigation and may turn out to be the model for future lawmaking, because global transactions and legal fragmentation are here to stay.

POSTSCRIPT

There is ongoing vibrant activity inside and outside the courts regarding all the three key cases discussed in this essay. An appeal from the English case of *Perpetual Trustee Company Ltd* is expected to be heard in the English Supreme Court during spring 2011. The US case was also appealed. The same litigation in the US is subject to a couple of motions; first, by Lehman Brothers to buy the perpetual notes,[77] and

---

74. ISDA issued an opinion clarifying the law following *Metavante, supra* note 6.

75. *See, e.g. Enron Australia, supra* note 31.

76. Another important legacy may emerge from the requirements of the rating agencies which are still developing their response to the US decision. Blamed for initial overreaction, they presently distinguish between US and non-US entities when they rate counterparties to swap contracts or securitisation .structures. *See* CLIFFORD CHANCE, NEW HORIZONS: LEGAL AND STRUCTURING DEVELOPMENTS FOR THE NEW INTERNATIONAL STRUCTURED DEBT PRODUCTS 66-67 (London, June 2010).

77. This was the subject of a court order on April 22, 2010.

second, by the trustee seeking declaratory judgment to resolve the impasse between the UK and US litigation. If Lehman Brothers indeed purchases the perpetual notes, the basis for the UK and US litigation will be removed and the resolution of the trans-Atlantic conflict in bankruptcy law may not take place.