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Lehman Brothers Holdings Inc.

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Neutral Citation Number: [2012] EWCA Civ 419

Case No: A2/2011/0070, A2/2011/0070(A), A3/2011/1107, A3/2011/2106 & A2/2011/1059

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT OF JUSTICE
CHANCERY DIVISION (COMPANIES COURT)
IN THE MATTER OF LEHMAN BROTHERS INTERNATIONAL (EUROPE) (IN ADMINISTRATION)
IN THE MATTER OF THE INSOLVENCY ACT 1986
&
ON APPEAL FROM THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
COMMERCIAL COURT
THE HONOURABLE MR JUSTICE BRIGGS & THE HONOURABLE MR JUSTICE FLAUX
[2010]EWHC 3372 (Ch), [2011] EWHC 718 (Ch), [2011] EWHC 1692 (Comm) & [2011] EWHC 692 (Comm)

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 03/04/2012

Before :

THE RIGHT HONOURABLE LORD JUSTICE LONGMORE
THE RIGHT HONOURABLE LORD JUSTICE PATTEN
and
THE RIGHT HONOURABLE LORD JUSTICE TOMLINSON

- -

Between :

A2/2011/0070 (A) & A2/2011/0070	**LOMAS & ORS (TOGETHER THE JOINT ADMINISTRATORS OF LEHMAN BROTHERS INTERNATIONAL (EUROPE))**	**Appellant**
	-and-	**Respondents**
	1) JFB FIRTH RIXSON INC & ORS **2) FR ACQUISITIONS CORPORATION (EUROPE) LTD** **3) BEIG MIDCO LTD** **4) KP GERMANY ZWEITE GMBH**	
	-and-	
	INTERNATIONAL SWAPS ANDDERIVATIVES ASSOCIATION INC.	**Intervener**

Mr William Trower QC & Mr Daniel Bayfield (instructed by **Linklaters LLP**) for the **Appellants**
Mr Mark Hapgood QC & Mr Henry Forbes Smith (instructed by **MacFarlanes LLP**) for the **first and second Respondents**, **Mr Robin Dicker QC & Ms Joanna Perkins** (instructed by **Clifford Chance**) for the **Third Respondents**, Mr **Richard Fisher** (instructed by **Freshfields Bruckhaus Deringer**) for the **fourth Respondents**
Mr Antony Zacaroli QC & Mr Jeremy Goldring (instructed by **Allen & Overy LLP**) for the **Intervener**

-and-

A2/2011/1059	**LEHMAN BROTHERS SPECIAL FINANCING INC**	**Appellant**
	-and-	

CARLTON COMMUNICATIONS LIMITED **Respondent**
-and-
INTERNATIONAL SWAPS AND DERIVATIVES ASSOCIATION INC. **Intervener**

Mr Jonathan Nash QC (instructed by **Weil Gotshal & Manges**) for the **Appellants**
Ms Felicity Toube QC (instructed by **Hogan Lovells International LLP**) for the **Respondent**
Mr Antony Zacaroli QC & Mr Jeremy Goldring (instructed by **Allen & Overy LLP**) for the **Intervener**

-and-

A3/2011/2106 **PIONEER FREIGHT FUTURES COMPANY LIMITED (IN LIQUIDATION)** **Appellant**
-and-
COSCO BULK CARRIER COMPANY LIMITED **Respondent**

Mr Charles Kimmins QC & Mr Luke Pearce (instructed by **Herbert Smith LLP**) for the **Appellant**
Mr Richard Jacobs QC & Mr Siddharth Dhar (instructed by **Thomas Cooper**) for the **Respondent**

-and-

A3/2011/1107 **BRITANNIA BULK PLC (IN LIQUIDATION)** **Respondent**
-and-
BULK TRADING S.A. **Appellant**

Mr James Willan (instructed by **Berwin Leighton Paisner LLP**) for the **Appellant**
Mr Mark Phillips QC & Mr Stephen Robins (instructed by **Watson Farley & Williams LLP**) for the **Respondent**

Hearing date: 14th, 15th, 16th, 19th & 20th December 2011

- -

Judgment

Lord Justice Longmore:

Introduction:

1. This is the judgment of the Court, to which all members have made a substantial contribution.

2. These 4 appeals, two from Briggs J and two from Flaux J, were listed for hearing together and raise a number of questions of construction in relation to derivatives in the form of interest rate swaps and forward freight agreements on the International Swaps and Derivatives Association Inc (formerly the International Swaps Dealers Association Inc.) ("ISDA") form of Master Agreement which was published in 1992 and again in 2002 ("the Master Agreement"). Derivatives have come to occupy the time of many Chancery and Commercial judges and it is necessary to understand what they are. Mr Simon Firth of Linklaters has published an important monograph on the topic which (while we have to bear in mind that Linklaters are the solicitors of the first appellants in these cases) we have found most useful in wrestling with the questions of construction which need to be decided for the purposes of these appeals. He defines a derivative as (para 1-004):-

> "a transaction under which the future obligations of one or more of the parties are linked in some specified way to another asset or index, whether involving the delivery of the asset or the payment of an amount calculated by reference to its value or the value of the index. The transaction is therefore treated as having a value which is separate (although derived) from the values of the underlying asset or index. As a result, the parties' rights and obligations under the transaction can be treated as if they constituted a separate asset and are typically traded accordingly."

3. Although derivatives can be quite complex, the theory behind the ones in issue in these cases is simple. Under the interest rate swaps, one party is to pay a floating rate of interest on a notional sum (notional because there is no actual loan) over a period of (say) 6 months. The other party is to pay a fixed rate of interest on the same notional sum over the same period. At the end of each six month period two calculations are done and one party will be "in the money" and the other "out of the money". That latter party will then pay the other the difference. This contract can be used as a pure speculation or (as in the present cases) be used as a hedge if one of the parties has a long term loan on interest.

4. Similarly the form of a forward freight agreement ("FFA") is that one party agrees to pay a fixed rate of notional freight while the other party agrees to pay a rate derived from an index published (normally) by the Baltic Exchange. The difference at the end of a set period is then payable by one to the other depending on the movement of the index as compared with the fixed rate. This can also be used by parties to protect themselves against fluctuation in shipping rates or as a means of trading in futures.

5. The first question which arises in the first three appeals is whether obligations to make payments pursuant to the agreements subsist after the party to whom payment is due has committed an Event of Default and, if so, for how long. The Master

Agreement records that the parties have (or will have) entered into one or more Transactions governed by the Master Agreement and a "Confirmation" confirming the Transactions. There is set out in section 2(a)(i) of the Master Agreement an obligation on each party to make the payment specified in the Confirmation, followed by provisions in section 2(a)(ii) that such payment is to be made on the due date in the place specified in the Confirmation. Section 2(a)(iii) then provides as follows:-

> "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 …"

6. In broad terms the dispute is whether, when there is a Event of Default on the part of the party due to receive a payment, there is any obligation at all on the counterparty to make a payment and, if so, whether such obligation is initially suspended but then disappears or revives (and, if so, the point at which it disappears or revives) or remains in suspense indefinitely.

7. These issues are determinative of the first appeal which is confined to questions of construction (including implied terms) relating to Section 2 of the Master Agreement. In the second appeal ("Carlton") the claimant also relies on an argument that the operation of Section 2(a)(iii) engages the anti-deprivation principle recently considered by the Supreme Court in Belmont Park Investments Pty Ltd v BNY Corporate Trustee Securities Ltd [2011] UKSC 38; [2011] Bus. L.R. 1266.

8. The issue which arises in the third appeal also raises a question of construction concerning the rights of the parties in the event of Termination following an Event of Default. The Master Agreement will typically or often comprise a number of individual transactions which by Section 1(c) of the Master Agreement are deemed to form a single agreement. The Master Agreement gives to the Non-defaulting Party a right to terminate in certain circumstances consequent upon an Event of Default and the parties may opt for Automatic Early Termination ("AET") upon the occurrence of certain "Bankruptcy Events of Default". In the event of Termination the Master Agreement prescribes a regime of "close-out netting". The issue which arises on the third appeal is whether obligations which have arisen or would but for Section 2(a)(iii) have arisen under individual transactions whose natural term has expired prior to the occurrence of AET affecting the single agreement as a whole are subject to close-out netting. As will be seen that issue is in our view concluded by resolution of the issues determinative of the first appeal.

9. The fourth appeal raises a distinct point concerning the operation of the close-out netting provisions consequent upon AET. It concerns the question whether, in certain circumstances, the close-out netting provisions require an assumption to be made that the Defaulting Party would in fact have satisfied the conditions precedent to its entitlement to receive payment from the Non-defaulting Party.

The outline facts of the First Appeal

10. The problem has arisen in the Lehman Brothers administration. One of the Lehman companies, Lehman Brothers International (Europe) ("LBIE"), was a party to numerous interest rate swap Transactions and went into administration on 15th

September 2008. That constituted an Event of Default under each of the agreements for the Transactions; to the extent that the counterparties owed any sums to LBIE on and after that date pursuant to such agreements, the obligation to make any payments either did not come into existence or ceased to exist or was suspended for the duration of the event of default which has continued while the administration is progressing. In the first of the cases under appeal the administrators wish to collect the sums purportedly owed to LBIE pursuant to 5 transactions made with

i) JFB Firth Rixson Inc ("JFB");

ii) FR Acquisitions Corporation (Europe) Ltd ("FRAC"); both these companies are part of the Firth Rixson group of companies which makes and supplies rings, industrial forgings and other specialised metal products ("Firth Rixson");

iii) BEIG Midco Ltd ("BEIG") part of the Bird's Eye Iglo group of companies; and

iv) KP Germany Zweite GmbH ("KPGZ") part of the Klockner Pentaplast group of companies which make plastic products.

11. The JFB transaction was a sterling interest rate swap evidenced by a Confirmation of 13th November 2007. The FRAC Transaction was a US Dollar interest rate swap evidenced by a Confirmation of 13th November 2007 novated to FRAC on 29th August 2008. The BEIG Transaction was a sterling interest rate swap evidenced by a Confirmation of 30th January 2007. KPGZ made two transactions, a Euro interest rate swap evidenced by a Confirmation of 4th December 2007 and a US Dollar interest rate swap evidenced by a Confirmation of 21st January 2008. All these Transactions had a maturity date after 15th September 2008 when the administrators were appointed and, on that maturity date, large sums were or, but for the Event of Default on LBIE's part, would have been or become due. It is those sums which the administrators seek to recover.

The Master Agreement

12. The scheme of the Master Agreement (1992) is relevantly as follows:-

i) The Master Agreement and all Confirmations form a single agreement between the parties;

ii) Section 2(a) constitutes the underlying obligation (as already set out) that each party will make payment to the other (in the case of an interest rate swap, one party the amount of fixed rate interest, the other party the amount of the floating rate interest for the relevant period);

iii) Section 2(c) provides for netting where the amounts otherwise payable are in the same currency and in respect of the same transactions;

iv) Section 2(e) provides for a party who defaults in the performance of any payment obligation to pay interest on the overdue amount at what is called "the Default Rate";

v) Section 3 sets out the representations made to each party by the other;

vi) Section 4 sets out certain subsidiary agreements;

vii) Section 5(a) enumerates many different occurrences constituting events of default e.g. failure to make a payment when due if such failure is not remedied on or before the 3rd Local Business Day after notice of failure is given to the non-paying party or failure to comply with other terms of the Agreement if such failure is not remedied on or before the 30th day after notice of failure is given; these are examples of potential events of default which become actual events of default once the notice period has expired;

viii) Section 5(a)(vii) is the relevant Event of Default for the purposes of this appeal. It is headed "Bankruptcy" and has 9 sub-sections including

> "(6) seeks or becomes subject to the appointment of an administrator, provisional liquidator … or other similar official.
> …"

LBIE had administrators appointed on 15th September 2008. This constituted an immediate Event of Default which has continued to this day. It looks as if it will continue for some time. While the administrators hope that they can ultimately find a surplus of assets over liabilities, they are by no means confident that that will be the position;

ix) Section 5(b) enumerates what are called "Termination Events" including at sub-section (v) any "Additional Termination Event" specified in the Schedule to the ISDA agreement or in any Confirmation. Sometimes the Schedule or the Confirmation will opt for AET if there is an Event of Default, but that was not the position in any of the 5 transactions which are the subject of the first appeal, nor indeed in the transactions with which the second appeal is concerned;

x) Section 6 is entitled "Early Termination" and gives a right to any Non-defaulting party, by giving not more than 20 days notice to the Defaulting Party specifying the relevant Event of Default, to designate a day (no earlier than the day the notice is effective) as an Early Termination Date in respect of all outstanding Transactions. If AET has already been selected in the Schedule to the Agreement or the Confirmation, an Early Termination Date will occur immediately, at any rate where the Event of Default is the appointment of an administrator. In cases where no AET has been selected this sub-section makes theoretical the question whether an Event of Default constitutes a repudiation of the Transaction; the answer is that it does not matter whether such Event of Default is a repudiation of the Transaction because the Non-defaulting party always has the option of designating a date when the transaction will terminate. The only restriction (if it be a restriction) is that such termination will apply to "all outstanding Transactions" between the parties rather than merely the Transaction in respect of which there has been an Event of Default;

xi) Section 6(b) deals with the right to terminate following a Termination Event but nothing turns on this sub-section for the purpose of this appeal;

xii) Section 6(c) then deals with the effect of designating an Early Termination Date and provides:-

> "(ii) Upon the occurrence or effective designation of an Early Termination Date, no further payments … under section 2(a)(i) or 2(e) in respect of the Terminated Transactions will be required to be made, but without prejudice to the other provisions of this Agreement. The amount, if any, payable in respect of an Early Termination Date shall be determined pursuant to section 6(e)."

xiii) Section 6(e) then deals with payments to be made on Early Termination. The details of this sub-section are only marginally relevant to this appeal but, in broad outline, the parties are supposed (in the 1992 Master agreement) to have elected in the Schedule to the Agreement a payment measure (either "Market Quotation" or "Loss") and a payment method (either "First Method" or "Second Method"). If no election has been made, then "Market Quotation" is deemed to be the measure and "Second Method" is deemed to be the method. These terms are all defined in the Definitions Section (Section 14) of the Agreement. If Second Method and Market Quotation apply, then an amount will be payable broadly equal to

a) the sum of the "Settlement Amount" determined by the Non-defaulting Party in respect of the Terminated Transactions and the "Unpaid Amounts" owing to the Non-defaulting Party less

b) the "Unpaid Amounts" owing to the Defaulting Party.

An important aspect of these calculations is that, subject to the point which arises in the fourth appeal, the Agreement requires it to be assumed that each applicable condition precedent has been satisfied. Any positive number will be paid to the Non-defaulting Party by the Defaulting Party; the absolute value of any negative number will be paid to the Defaulting Party by the Non-defaulting Party. The terms "Settlement Amount" and "Unpaid Amount" are also defined in the Definitions Section and need not be set out here. The important general point is that, if the Non-defaulting Party elects to designate an Early Termination Date in respect of all transactions, sums due to the Defaulting Party will (subject to any other relevant terms of the Agreement) be brought into account, as they will if the parties have elected for AET. Section 6(e) is often referred to as a provision for "close-out netting";

xiv) Sections 7 and 8 deal with transfers of the Agreement (and interests and obligations thereunder) and the Contractual Currency of the Transactions;

xv) Section 9 has various miscellaneous sub-sections including

"c) Survival of Obligations

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

This provision was subjected to detailed argument both before Briggs J and before us.

13. The important point for the purpose of this appeal is that the Non-defaulting Parties never did designate an Early Termination Date, although they could have done so if they wished. The consequence is that Section 6 of the Agreement was never applied and the transactions were not (and never have been) terminated. This was no accident because, at the time when administrators were appointed, sums were "due" (or likely to become "due") from the Non-defaulting Parties to LBIE. As the months passed more and more sums did become "due" to LBIE and the administrators say that those sums should be paid or (where relevant) brought into account in assessing the overall sums "due" to the parties. The Non-defaulting Parties say that no such sums ever became "due" because their obligation to make the relevant payment under Section 2(a)(i) is and was at all material times (by virtue of Section 2(c)(iii)) subject to the condition precedent that no Event of Default "has occurred and is continuing".

14. The relevant transactions have now all come to the end of their term (or will shortly do so). Both the administrators and the Non-defaulting Parties want to know their legal position. The Administrators have accordingly applied for directions under paragraph 63 of Schedule B1 of the Insolvency Act 1986 and asked Briggs J to determine a number of questions. The broad upshot of the judge's decision is that, although an obligation on the part of the non-defaulting party came into existence on the due date of payment, it was suspended and later extinguished at the end of the natural term of each Transaction. As the judge said in para 89 of his judgment, in which he rejected perhaps the most plausible of the implied terms proposed by the administrators (that the condition precedent in section 2(a)(iii)(1) fell away at the end of the natural term of a transaction),

> "a payment obligation suspended by section 2(a)(iii) does not survive termination."

We read this as meaning the obligation to pay is suspended while an Event of Default continues and, if the Event of Default is not remedied, is then extinguished at the time when the transaction comes to an end at its maturity date.

The Arguments

15. Both at first instance and before this court Mr Trower QC for the administrators as applicants and appellants in the first appeal put forward a number of possible implied terms at least one of which was said to be necessary to make the interest swap agreements work as intended. The suggested implied terms were that the condition precedent suspending the obligation to pay during the existence of an Event of Default came to an end

    i) on the expiry of such time as was required to enable the Non-defaulting party to elect for early termination and consequent close-out netting; or

ii) on the expiry of a reasonable time if that was a different time; or

iii) on the expiry of (or maturity of) the relevant transactions; or

iv) on the expiry of (or maturity of) all transactions between the parties governed by the Master Agreement.

Mr Trower did not much mind which of his suggestions the court accepted but submitted it was necessary to accept one of them in order to make the contract work as intended. As an ultimate fall-back position, Mr Trower invited the court to accept the submissions made on behalf of ISDA as recorded in paragraph 19 below.

16. Mr Nash QC for Lehman Brothers Special Financing Inc (the appellants in the second appeal) opted for the fourth of the above possibilities.

17. Mr Hapgood QC and Mr Dicker QC for Firth Rixson and BEIG supported the judge's conclusion but submitted with varying degrees of enthusiasm that the judge should have held that the obligation of the Non-defaulting Party to make payment to the defaulting party was extinguished and once for all on maturity namely at termination plus any applicable cure period, if the Event of Default, remained un-remedied.

18. Mr Richard Fisher for KPGZ submitted more radically that, if an Event of Default occurred, no obligation on the part of the Non-defaulting Party came into existence at all so that no right was born, which needed to be either extinguished or revived.

19. ISDA conceived that they themselves had a legitimate interest in the true construction of their standard terms of Agreement and applied for (and were granted) leave to intervene both at first instance and in this court. Mr Zacaroli QC on ISDA's behalf submitted that the payment obligation came into existence on the due date and that the condition precedent (that there be no Event of Default) suspended the payment obligation in section 2(a)(i). It was, however, wrong both to talk of the condition precedent being extinguished on expiry of a reasonable time or on the maturity of the relevant transaction and to talk of the revival of the obligation to pay at any particular time. The obligation to pay on the Non-defaulting Party remained in suspension until such time as the suspension came to an end either by the correction of the Event of Default or the decision of the Non-defaulting Party to elect for termination. If the Non-defaulting Party never elected for termination, the obligation to pay continued to be suspended and that party took the risk that the Event of Default would be cured and the obligation to pay would then revive. If therefore the administration of LBIE came to an end without any other Event of Default (such as liquidation) occurring, the obligation of the Non-defaulting party to make payment to section 2(a)(i) would then revive.

20. The parties formulated a series of issues for the court to determine in the light of all these arguments and the judge dutifully resolved those issues in the course of his judgment and in his formal order. We would, however, prefer to approach the case in a somewhat more chronological order than the parties did. We will deal with the arguments in the following order:-

i) granted that the appointment of administrators on 15th September 2008 constituted an Event of Default, did that have the effect that no amounts ever

became due and payable from the Non-defaulting party to the Defaulting party?

ii) if such amounts did become due but were not payable by virtue of the Event of Default, did they never become payable or would they become payable if the Event of Default was cured?

iii) if they did become due and payable but were suspended by reason of the Event of Default, did that suspension end at any of the times suggested by the administrators so that the payment obligation then revived?

iv) conversely, if the suspension did not so end, was the obligation to pay extinguished at the expiry of (or the maturity of) the transactions?

v) if the obligation did not revive and was not extinguished at the end of the transaction, did it last for ever and, if not, when did it cease to exist?

Did the obligation of the Non-defaulting Party ever come into existence?

21. It is necessary here to draw a distinction between sums due but unpaid before the occurrence of an Event of Default (or, indeed, the fruition of a Potential Event of Default) and sums becoming due after the occurrence of the Event of Default. The parties to the first appeal accepted that sums due but unpaid before the occurrence of the Event of Default must be due and payable and remain due and payable. We do not believe it strictly necessary to decide conclusively in the first appeal whether this is correct but if we had to we would conclude that once such sums were due they should be paid regardless of any subsequent Event of Default. If, moreover, even sums already "due" at the time of the occurrence of an Event of Default did not have to be paid, that might be relevant to the arguments made on the second appeal in relation to anti-deprivation.

22. The question which we do have to resolve in this first appeal is whether sums become due at any time after an Event of Default has occurred. If it is a condition precedent that there be no Event of Default but the defaulting party is "in the money" at the next monthly payment date (or at any subsequent time), is such money due but not payable or does no obligation ever come into existence (as Mr Fisher for KPGZ contends)?

23. The judge dealt with this compendiously as part of what he called the "Once and for All" time point and he concluded that the obligation to pay on the Non-defaulting party was not something which was at once and for ever discharged if a sum became due from that party after an Event of Default. But there are logically two separate questions

i) Can any obligation arise at all on the part of the Non-defaulting Party once an Event of Default has occurred?

ii) If any such obligation does arise, is the effect of section 2(a)(iii) that the obligation is destroyed or merely suspended for a period of time?

24. For this purpose it is necessary to set out section 2(a) of the Master Agreement in full. Section 2 is headed "Obligations"; section 2(a) is headed "General Conditions" and provides:-

> "(i) 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.
>
> (ii) Payments under this Agreement will be made on the due date for value on that date in the place of the account specified in the relevant Confirmation or otherwise pursuant to this Agreement, in freely transferable funds and in the manner customary for payments in the required currency. Where settlement is by delivery (that is, other than by payment), such delivery will be made for receipt on the due date in the manner customary for the relevant obligation unless otherwise specified in the relevant Confirmation or elsewhere in this Agreement.
>
> (iii) Each obligation of each party under section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or potential Event of Default with respect to the other party has occurred and is continuing, (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."

This Section therefore focuses on the payment obligation of the parties but underlying any payment obligation, there is always a debt obligation. This can be seen from the relevant Confirmations. The KPGZ confirmations (with which we have been provided) nominated LBIE as the Floating Amount Payer and KPGZ as the Fixed Amount Payer. LBIE was obliged to pay every six months the floating rate of interest on the notional amount of $100,875,000 to KP and KPGZ was obliged to pay every 6 months a fixed rate of 5.485% per annum to LBIE. The payment dates are the last calendar dates of each June and December from 31st December 2007 up to and including the Termination Date which is defined as the earliest of (i) 9th July 2012 and (ii) the occurrence of the Termination Event. A mutual debt obligation therefore arose on the last day of each June and December from and after December 2007. There was also an obligation to make payment on that date. Thus the debt obligation and the obligation to make payment of the debt arose at the same time.

25. Section 2 of the Master Agreement is, however, all about the payment obligation and does not, in our view, touch the underlying indebtedness obligation. In particular, section 2(i) obliges each party to make each payment specified in the Confirmation and it is that payment obligation which is, by section 2(a)(iii), made subject to the condition precedent that no event of default has occurred and is continuing.

26. That this is so is demonstrated by the fact that the Master Agreement provides that, in cases where Early Termination occurs and payments have to be made pursuant to section 6(e) by reference to a payment measure which is to be either "Market Quotation" or "Loss", it is to be assumed that each applicable condition precedent has been satisfied. As already explained (see para 12 (xiii) above) that means that in the event of early termination, the net position of the parties is to be calculated. If in fact no debt obligation ever arose, the calculation envisaged as occurring on early termination could never take place since there would be no obligation of the Non-defaulting party to take into account.

27. Nor does Mr Fisher's argument cater conveniently for Potential Events of Default; these are just as likely to occur as actual Events of Default. It would be very odd if no obligation arose if a Potential Event of Default had occurred on or before a due date for payment but that fault was cured the day after the due date. Mr Fisher would no doubt say that the debt and the obligation to pay it did arise but would be extinguished if the Potential Event of Default became an actual Event of Default but it is most unlikely that the parties could have intended that the indebtedness should come into existence for one kind of default but not for the other.

28. A similar argument to that advanced by Mr Fisher was submitted to Gloster J by Mr Jonathan Crow QC in Pioneer Freight Co Ltd v TMT Asia Ltd [2011] 2 Lloyds Rep 96, a case about FFAs decided after the decision of Briggs J in the present case, at any rate in his oral reply (see para 72). It was rejected by her for much the same reasons as we have set out. She said in para 91

> "Once one approaches the analysis on the basis that, under Section 2(a)(iii), one is only looking at the payment obligation, rather than the debt obligation, the whole machinery makes sense. Thus, the wording of Section 2(a)(iii) makes it clear that the payment obligation is subject to the condition precedent that no Event of Default or Potential Event of Default has occurred "… and is continuing". The natural reading of those words envisages that once a condition precedent is fulfilled, the obligation to pay revives. There is no need for any further creation of the debt obligation itself, as Mr. Crow seeks to suggest"

We would respectfully adopt those observations of Gloster J and hold that the underlying debt obligation is undisturbed by the Event of Default; it is merely the payment obligation which is barred if there is an Event of Default. We turn therefore to the next question which is whether the obligation to pay is extinguished or is merely suspended so that it can and will revive if the Event of Default is cured before termination by either party or on the maturity of the transaction.

Extinction or Suspension?

29. This was dealt with by the judge in para 66-74 of his judgment under the heading "Once and for All v Suspension". The question had already been considered by Flaux J in Marine Trade SA v Pioneer Freight Futures Co Ltd BVI [2010] Lloyds Rep 631. He had concluded that, once there was an Event of Default, any obligation on the Non-Defaulting Party to pay the Defaulting Party was extinguished rather than suspended. Flaux J had not been referred to an earlier dictum of Austin J of the Supreme Court of New South Wales to the contrary in Enron Australia v TXU Electricity [2003] NSWSC 1169. In this case that learned judge had said:-

> "Since these two conditions are conditions precedent to the payment obligations of the counterparties, if either condition has not been met at any given time there is no payment obligation under any of the trades that have been made under the Agreement. However, a payment obligation will spring up under a pre-existing trade once the relevant condition is

> satisfied, and in that sense it might be said (with only approximate accuracy) that the payment obligation is "suspended" while the condition remains unfulfilled, and that amounts "accrue" notwithstanding that the condition is unfulfilled."

30. Briggs J gave 3 reasons for concluding "on a fairly narrow balance" that Austin J's suspensory construction was to be preferred. In the third of these appeals Flaux J has declined (in the light of these pending appeals) to express a final opinion but, left to himself, would probably have maintained his original opinion. We consider that on this matter Briggs J was correct.

31. Our first reason for so concluding is that to treat the payment obligation as extinguished is altogether too drastic a remedy in favour of the Non-defaulting Party because the possible Events of Default and potential Events of Default are so many and various. A small underpayment unremedied for three days perhaps as a result of a bona fide underlying dispute as to the amount due was one example given in argument. An unjustified presentation of a petition for the winding-up or liquidation of a company is another. The former is initially a potential Event of Default under section 5(a)(i) but becomes an actual Event of Default if it is not remedied on or before the third Local Business Day after notice of failure to pay is given. The latter is also a potential Event of Default but section 5(a)(vii)(4) requires that such petition should (A) result in an order for winding-up or liquidation or (B) not be

> "dismissed, discharged, stayed or restrained … within 30 days of the institution or presentation thereof."

30 days is a comparatively short time for the Defaulting Party to ensure that a winding-up petition is conclusively dismissed or restrained; it would not, for example, allow time for any appeal. Moreover in the 2002 ISDA Master Agreement the time is shortened to 15 days. It would not be reasonable to hold that, if the Defaulting Party is able to remedy the position in either of these cases but only after the short timescale has expired, his rights against the Non-defaulting Party have forever gone and can never revive. It is more natural to hold (as we do) that the obligation to pay is suspended while the relevant Event of Default continues.

32. Secondly, we agree with Briggs J that, granted that the calculations of loss in relation to Early Termination or AET require it to be assumed that any condition precedent has been satisfied, it would be somewhat counter-intuitive to find that in other cases the existence of the relevant condition precedent means that the underlying obligation is extinguished rather than suspended. A deferred election for early termination could cause serious problems of analysis.

33. Thirdly we do not agree with Mr Jacobs QC for Cosco that this question of construction is assisted by remembering that the Master Agreement potentially applies to delivery of chattels (for example financial instruments) as much as to the payment of money pursuant to interest swap or forward freight agreements. It is no doubt true that the value of such chattels may increase during any period for which the delivery obligation may be suspended but, if the Non-defaulting Party thinks that is an unsatisfactory position, he can invoke the rights given by Section 6 in relation to Early Termination.

34. Nor do we think that the question whether the obligation of delivery comes into existence (or is extinguished) if a condition precedent is not satisfied at the date of the accrual of the obligation can be resolved by reference to the general law of the sale of goods (as Flaux J appears to have thought in para 87 of his judgment in the third case under appeal (Pioneer v Cosco)). That must depend on the terms of any individual contract but in the case of a long-term contract for delivery of goods by instalments (which is the closest analogy) any repudiatory breach would give the innocent party the option to terminate but, if he does not so terminate, the contract stays alive and the innocent party takes the risk that the terms of the contract will on their true construction permit the party in breach to call for delivery at a later date. In a similar way a party who does not accept a repudiatory breach as terminating the contract takes the risk of a frustrating event occurring which will release the guilty party from his obligations, see Avery v Bowden (1855) E&B 714. We therefore prefer the view expressed in para 11-012 of Firth on Derivatives that the conclusion we have reached (that performance of an obligation of payment or delivery is suspended during the currency of a relevant event of default)

> "is consistent with the treatment of concurrent conditions in, for example, contracts for sale of goods. Under such contracts neither party has to perform if the other party is not ready and willing to do so, as each party's obligations are conditional on simultaneous performance by the other party. However, if a party fails to perform on the due date, the innocent party is not released (unless the contract is validly terminated); if the party in breach subsequently tenders performance, the innocent party must perform its own obligation."

35. We would therefore decide that the payment obligation of the Non-defaulting Parties is suspended (rather than extinguished) during the currency of an Event of Default under the Master Agreement and will revive if the Event of Default is cured at any time before the outstanding Transactions are terminated. The question then arises whether the payment obligation revives at any other time while the contract continues to exist and whether (if not) the obligation is extinguished when the contract arrives at its contractual maturity date.

Revival otherwise than by curing the Event of Default?

36. Mr Trower QC for the administrators submitted that, even if the Event of Default was not cured but continuing, there must come a time when the obligation on the Non-defaulting Party to make payment must revive. Otherwise there would be a serious mismatch between the situations of Early Termination or AET on the one hand and the absence of Termination on the other. Also, it would always be in the interest of the Non-defaulting Party to decline to terminate the transaction and keep it in existence in the knowledge that however much the Non-defaulting Party might owe and however much the Defaulting Party might be "in the money", the Defaulting Party could never recover. The Non-defaulting Party would thus receive a totally undeserved windfall. This was so unfair on the Defaulting Party that a term as to the revival of the payment obligation had to be implied into the contract.

37. The judge (para 81) set out the 3 terms which the administrators at that stage of the proceedings sought (as a matter of construction) to imply into the agreements between

the parties, any one of which would produce a satisfactory outcome from the administrators' point of view. They are:-

> "A. That Section 2(a)(iii) suspends the Non-defaulting Party's payment obligations under condition precedent (1) only for a reasonable time: that is, a time sufficient to enable that party to decide whether to elect for Early Termination, or to continue to perform its payment obligations in full.
>
> B. That section 2(a)(iii) suspends the Non-defaulting Party's obligations under section 2(a)(i) until such time as the Transaction, or alternatively all of the Transactions between the parties governed by the Master Agreement, have run their course (assuming no Early Termination) such that, at the expiry of the natural term of the last Transaction the Non-defaulting Party must either submit to a netting process which calls for payment of all suspended payment obligations or submit to the consequences of an Early Termination as at that date.
>
> C. That the Non-defaulting Party is, under section 6(a), under a constant obligation to exercise its discretion whether or not to designate an Early Termination Date in a manner which is not arbitrary, capricious or unreasonable so that, once it is clear that the other party's default is permanent, or where the Non-defaulting Party decides to re-hedge, it must exercise its discretion in favour of Early Termination."

38. The judge rejected all these possibilities and we agree with him.

(A) Revival after reasonable time

39. The first proposed term is not only not a necessary implication to make the contract work but it is contrary to the express words of section 2(a)(iii) "… and is continuing".

40. It is, of course, the case that when a contract requires something to be done and no time limit for the doing of that act is expressly stipulated, the court will often imply that it should be done within a reasonable time. The paradigm example is perhaps that of a cif seller who has to forward the bills of lading to his buyer within a reasonable time (which may, in some circumstances, be a very short time) see Sanders v Maclean (1883) 11 QBD 327. But in this case the only act required of the Non-defaulting Party is to make payment, the time for doing of which is set out in the contract which also provides that payment need not be made while the Event of Default is continuing. There is just no reason for any implication that the Non-defaulting Party is to do any other act within any particular time, let alone the act which the clause says he need not do.

41. The suggestion that the scheme of the contract requires the Non-defaulting Party (within a reasonable time) to opt for Early Termination does not hold water. In the first place the parties were able to opt for AET if they wanted to. In the first appeal and the second appeal the parties did not do that. In the second place, the whole point of Section 6 is to give the Non-defaulting Party the option to "designate a date … as

an Early Termination Date in respect of all outstanding Transactions". This is a right which is given to the Non-defaulting Party and it is not easy to see why there should be any limitation on the right. It is not an unqualified right because the Defaulting Party can cure the default if he is able to do so within the 20 day notice period which the Non-defaulting Party has to give. It has also to be recalled (see para 12 (x) above) that, if the option is exercised, then the Early Termination date so chosen applies to "all outstanding transactions". It is not an option to terminate one transaction and leave other transactions un-terminated. That will not necessarily be entirely beneficial to the Non-defaulting Party but he has to take that on the chin as the price of the exercise of the option. Mr Trower's proposed implied term would require the Non-defaulting Party (after a reasonable time, whatever that might be) to terminate all outstanding transactions not just the transaction to which the event of default (e.g. non-payment of a particular sum) related. There is just no reason why the Non-defaulting Party should be required to opt in this way.

42. On the facts of the present case, moreover, the Non-defaulting Party needs protection against the continuing insolvency of LBIE. To the extent that the Non-defaulting Party is "out of the money" because the floating rate is (or is likely to be) less than the fixed rate of interest it may be that his loss is more theoretical than real because he can go into the market and obtain another swap transaction on more beneficial terms than the transaction with LBIE; but if the Non-defaulting Party is "in the money" because the floating rate is (or is likely to be) higher than the fixed rate, any new swap obtainable in the market would be likely to be more expensive then the transaction with LBIE. Although he may have a claim against LBIE for the difference, such a claim will only be as an unsecured creditor in what is likely to be an insolvent administration. The Non-defaulting Party is, however, entitled to be the guardian of his own interest and make his own assessment whether early termination is likely to be to his benefit or not. It cannot have been the intention of the parties that he should be constrained to make a choice in favour of early termination at any particular time, not of his own choosing.

(B) Revival at the maturity of the Transaction or all outstanding Transactions

43. The question whether this suggested term can be implied into the contract is, in a sense, part of the larger question whether the transaction comes to an end on maturity. In one sense it does since, after the relevant number of months or years have elapsed, no more calculation of amounts due either way will be made any more. But that may not be the end of the matter since there may still be accrued obligations. Mr Trower on behalf of the administrators of LBIE submits that, if there is a single transaction governed by a single Confirmation, that transaction does indeed come to an end and, at that time, any sums due from the Non-defaulting Party to the Defaulting Party must be paid. Mr Hapgood for Firth Rixson and Mr Dicker for BEIG (supported by Mr Fisher for KPGZ on the basis that we have decided his earlier point against him) agreed that the transaction came to an end but drew the opposite conclusion, namely that the condition precedent to payment (that there be no Event of Default) continued in force and that nothing was due from the Non-defaulting Party then or at any future time. The judge accepted this latter submission and we shall shortly have to determine whether he was right to do so. He rejected Mr Trower's submission saying (para 89) that it was more obviously at variance with the language of the Master Agreement than Mr Trower's earlier submission. On this we agree with him.

44. To some extent the reasons why this implication cannot be made are the same as those already given for rejecting the previous implied term. There is just no reason to make the implication since the contract works perfectly well without it. Where, indeed, there was more than one transaction (as there was for KPGZ) it would be unjust if, at the maturity of the first transaction, the Non-defaulting Party had to pay whatever might be due, when market forces might be flowing the other way under the second transaction, since the result of that could well be the Non-defaulting Party would have to pay upfront but, when he came into the money on the second transaction, he would not be able to recover what was due as a result of the Defaulting Party's insolvency.

45. Faced with this dilemma, Mr Trower submitted that the correct implication was that the payment obligation would revive after the end of all the outstanding transactions made between the parties. But it would be surprising to imply a term into any particular transaction which would have to await the maturity or termination of other transactions. That would be to re-write the contract for the parties which it is no business of the court to do. The court will only imply terms if it is necessary to do so or if it would be obvious to any disinterested third party that the contract must have the meaning which the implied terms would give it. But the second suggested implication satisfies neither of those tests.

(C) Requirement to exercise discretion reasonably

46. The administrators did not pursue this third suggested implied term on the appeal. Had they done so, we would have rejected it because it is even more hopeless than the others. The right to terminate is no more an exercise of discretion, which is not to be exercised in an arbitrary or capricious (or perhaps unreasonable) manner, than the right to accept repudiatory conduct as a repudiation of a contract. We have already commented that the specific right to terminate makes theoretical the question whether an Event of Default constitutes a repudiation of the contract which can be accepted by the innocent party as bringing the contract to an end. But no one would suggest that there could be any impediment to accepting repudiatory conduct as a termination of the contract based on the fact that the innocent party can elect between termination and leaving the contract on foot. The same applies to elective termination. Even if, moreover, it could be said that in some sense a contracting party had a discretion to bring the contract to an end and that such discretion should not be exercised capriciously or arbitrarily, it by no means follows that the same considerations could apply to allowing the contract to continue which does not require any positive act on the part of the Non-defaulting Party.

47. We would therefore reject all the formulations of an implied term put forward on behalf of the administrators of LBIE in the first appeal. It follows that we reject the similar arguments (although confined, as we understand it to the second formulation) put forward by Mr Nash QC in the second appeal. We turn therefore to the converse question whether the payment obligation comes to an end on the maturity of the relevant transactions.

Extinction of payment obligation on maturity?

48. The judge held that, although the payment obligation of the Non-defaulting Party was suspended during the currency of the transaction, the suspension ended on maturity and it was then extinguished. He pointed out that the only alternative to extinction on

maturity was that the payment obligation would last indefinitely. By that he presumably meant that it would last until such time as the Non-defaulting Party chose Early Termination and closed out all outstanding transactions or such time as the Event of Default was cured. If the Non-defaulting Party never chose early termination and the Event of Default could never be cured, the obligation would indeed be indefinite but it would be an obligation which could never be called in.

49. The judge gave three reasons for coming to this conclusion (1) that it would not be a reasonable understanding of the Master Agreement to continue it in such a way as to give rise to indefinite contingent liabilities (2) that on its true construction Section 9(c) provided for extinction of the payment obligation (3) that the downside of indefinite contingent liability could not be avoided by Early Termination since the Termination would not be early and it would be impossible to apply the default method for calculating the relevant payments since there could be no market for a replacement swap. The first and third reasons are inter-related so we will consider Section 9(c) first which, as will be remembered by any reader of this judgment, provides:-

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

50. The exclusion of Section 6(c)(ii) is readily understandable since that is the provision stating that the effect of designating an Early Termination Date is that no further payment or deliveries are to be made but that amounts, if any, payable by one party to the other will be determined pursuant to Section 6(e) including Market Quotation and Second Method as the default measure and payment method. The obligation to make any resultant payment obviously has to survive the termination of any transaction. In the absence of section 9(c) it could hardly be arguable that no such obligation accrued, but Section 9(c) puts that matter beyond doubt.

51. The previous form of ISDA Agreement published in 1987 under the title of Interest Rate and Currency Exchange Agreement had clause 2(a)(iii) and 9(c) in a slightly different form. Clause 2(a)(iii) had no reference to the second condition precedent in the 1987 form (absence of occurrence or designation of early termination) and provided simply:-

> "(iii) Each obligation of each party to pay any amount due 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 and (2) each other applicable condition precedent specified in this Agreement."

Section 9(c) had no reference to Section 2(a)(iii) at all but provided simply:-

> "Survival of Obligations

> Except as provided in Section 6(c)(ii), the obligations of the parties under this Agreement will survive the termination of any Swap Transaction."

52. Since Section 9(c) in the 1987 Agreement made no reference to Section 2(a)(iii) it seems to us impossible to construe Section 9(c) in the 1987 Agreement as providing that any suspended payment obligation should be extinguished on maturity. The question is whether the new wording of Section 9(c) in the 1992 form of Agreement introduced, for the first time (without saying so expressly), the concept that the payment obligation, suspended as it is once there is an Event of Default, is to be extinguished on maturity.

53. We cannot conclude that, as a matter of construction, so fundamental an alteration has been achieved by the new wording. The judge himself (who had not been referred to the 1987 form) says that Section 9(c) is by no means ideally phrased (para 79) and that it was:-

> "perhaps inelegant language for the purpose of encapsulating the concept that a payment obligation suspended by Section 2(a)(iii) does not survive termination" (para 89).

It is easy to see why, once Section 2(a)(iii) of the 1992 Agreement added the new condition precedent to payment that no Early Termination Date should have occurred or have been designated, Section 9(c) should have added a reference to Section 2(a)(iii), which now referred to Early Termination for the first time, but it cannot, in our judgment, have been the intention of the framers of the 1992 Agreement to introduce the concept of extinction of the payment obligation by the use of such "non-ideal" and "inelegant" wording. If that had been their intention, they would have made that intention much more explicit than by hiding it in a clause headed "miscellaneous" and phrasing it in such an obscure manner. The reference in Section 9(c) to Section 2(a)(iii) is, in our view, a reference only to Section 2(a)(iii)(2).

54. This conclusion does not, of course, affect the judge's other reasons for construing the agreement to provide for extinction of the obligation on maturity of the transaction but it must be noted that these other reasons go to support the implication of such a term in the absence of any express term to that effect. The position is that the parties have made no express provision for what is to happen to suspended obligations when the transaction matures and the question is, therefore, whether the court should imply a term that such obligations are indeed to be extinguished.

55. Both the first and third reasons given by the judge do not seem to us, with respect, sufficient reasons to justify an implication that suspended obligations are to be regarded as extinguished. They both amount to saying that indefinite contingent liabilities are inconvenient. No doubt that is so but that consideration forms a slender basis for implying a provision for extinction which the parties have not expressly agreed.

56. We have so far avoided any extended reference to the law on implied terms since it seems to us that, on any view of the law, it is impossible to imply any of the terms suggested by Mr Trower for the administrators. Once one appreciates, however, that the Non-defaulting Parties are seeking to imply a term (albeit a different term) just as

much as the administrators are, it is necessary for us to remind ourselves of the latest authoritative pronouncement about implied terms in the judgment of the Privy Council in Attorney General of Belize v Belize Telecom Ltd [2009] 1 WLR 1988. The facts of the case are a long way from those of the present appeals but the decision of the Judicial Committee of the Privy Council gives important general guidance. In delivering judgment Lord Hoffmann said:-

> "The question of implication arises when the instrument does not expressly provide for what is to happen when some event occurs. The most usual inference in such a case is that nothing is to happen. If the parties had intended something to happen, the instrument would have said so. Otherwise, the express provisions of the instrument are to continue to operate undisturbed. If the event has caused loss to one or other of the parties, the loss lies where it falls.
>
> In some cases, however, the reasonable addressee would understand the instrument to mean something else. He would consider that the only meaning consistent with the other provisions of the instrument, read against the relevant background, is that something is to happen. The event in question is to affect the rights of the parties. The instrument may not have expressly said so, but this is what it must mean. In such a case, it is said that the court implies a term as to what will happen if the event in question occurs. But the implication of the term is not an addition to the instrument. It only spells out what the instrument means."

and again:-

> "It follows that in every case in which it is said that some provision ought to be implied in an instrument, the question for the court is whether such a provision would spell out in express words what the instrument, read against the relevant background, would reasonably be understood to mean."

57. The question for the court is, therefore, whether the contracts in the present appeals "mean" that the suspended payment obligation disappears on the maturity of the transaction. Neither the Confirmation nor the Master Agreement so state expressly and we do not consider that the contracts "must" mean that. The parties have just made no provision on the topic and the loss (such as it is) must lie where it falls.

58. It should also be said that termination after the natural maturity date can be "early" termination. It would only be if one assumes that the payment obligation is extinguished at that time that it becomes odd to talk of early termination thereafter. For the reasons given we do not consider that the payment obligation is extinguished; it will still be possible for the Non-defaulting Party to terminate "early" thereafter, if he wishes to do so. If he does not wish to do so, he has to accept the consequence of the contractual obligations continuing to exist.

59. Nor do we follow the judge's third reason that it is impossible to conduct the required calculation (whether "Market Quotation" or otherwise) after the maturity date of the transaction. It merely means that the first part of the calculation results in a nil figure which is then to be compared with the second part of the calculation.

60. We were much pressed with the decision of the House of Lords in Total Gas Marketing Ltd v Arco British Ltd [1998] 2 Lloyds Rep 209 in which a long term contract for the sale and delivery of natural gas from the Trent Gas Field in the North Sea was conditional on the seller becoming a party to an allocation agreement required by the gas terminal in Norfolk where the raw gas was processed. A clause in the contract gave the seller (Arco) the option to fix the first delivery date within the period 15th September – 15th December 1996 and Arco did so fix it for 31st October 1996. But by the time that date arrived, Arco had not become a party to the allocation agreement and, in the light of a fall in gas prices, the buyer (Total) declared that they were no longer obliged to take delivery. Jonathan Parker J and Nourse LJ decided that Total were not entitled to take that course but the majority of the Court of Appeal and all the members of the House of Lords decided that, once the delivery date had been effectively written into the contract, that date was sufficiently important to compel the conclusion that, if Arco had not become a party to the relevant allocation agreement, Total were entitled to regard themselves as no longer bound.

61. We cannot regard this case as affording any assistance in the different world of derivatives in the form of interest rate swaps and forward freight agreements. In the first place, the condition of becoming a party to the allocation agreement was a contingency on the fulfilment of which the contract itself depended – no obligation to accept and pay for the delivery could come into existence until the contingency occurred. In the present case, the contracts had come into existence and had been partially performed; the question here is whether existing obligations have been extinguished, not (once Mr Fisher's submissions have been rejected) whether they have come into existence at all. Secondly the question whether existing obligations are extinguished can (in the absence of an express term on the matter) only be determined by resorting to implication (in the Belize sense). There was no question of any implication having to be made in Total v Arco.

Duration

62. We decide therefore that Mr Zacaroli's submissions are correct and that there is no terminus, either by way of extinction or revival, to the condition precedent. It continues in force until the Event of Default is cured. If it is never cured, there continues to be no obligation on the Non-defaulting Party to make payment.

Conclusion on First Appeal

63. For these reasons, it follows that the Administrators' appeal must fail, save to the extent that this court has accepted ISDA's submissions and thus endorsed their ultimate fall-back position identified in paragraph 15 above. No doubt in the light of our difference from the view of the judge on the question of the extinction of the payment obligation on maturity, it may be necessary to make some amendments to his formal order but that makes no difference to the outcome of the appeal. We will ask the parties to co-operate in drawing up a new order.

The facts of the second appeal

64. The second appeal (Lehman Brothers Special Financing Inc ("LBSF") v Carlton Communications Limited ("Carlton")) concerns two linked interest rate swaps incorporating the terms of the ISDA (1992) Master Agreement which were entered into to enable Carlton to hedge its fixed interest exposure. In the Schedule to the Master Agreement the parties elected against Automatic Early Termination and chose the Second Method and Loss under Section 6(e).

65. Under the first swap LBSF paid a fixed rate of interest on the notional amount of £250m on 2nd March and 2nd September in each year from 2nd March 2005 to 2nd March 2009. Carlton paid a floating rate based on sterling LIBOR. Under the second swap LBSF was also the fixed rate payer and Carlton the floating rate payer. The payment dates were the same as under the first swap.

66. LBSF was the principal group company engaged in fixed income OTC derivatives business. Its parent company was Lehman Brothers Holdings Inc ("LBHI") which acted as LBSF's Credit Support Provider for both swaps under the terms of the Master Agreement.

67. At the date of the Lehman Group collapse in 2008 only one payment date remained under each of the swaps. LBHI entered Chapter 11 bankruptcy on 15th September followed by LBSF on 3rd October. There were therefore two relevant Events of Default which continued on 2nd March 2009 which was the last payment date. As of then LBSF was in the money and but for the operation of Section 2(a)(iii) would have been entitled to a payment from Carlton of £2,656,649.31.

The issues on the second appeal

68. The principal issues on the second appeal are the effect of an Event of Default on the subsequent payment obligations of the Non-defaulting Party and whether on the maturity of the swaps in March 2009 those payment obligations were either extinguished or revived. At the trial it was common ground that the non-satisfaction of the condition precedent in Section 2(a)(iii)(1) was suspensory only (as opposed to once and for all) although the judge's analysis in his Firth Rixson judgment meant that in practice this made no real difference to the outcome given that 2nd March 2009 was also the maturity date of the contracts. But Ms Toube QC on behalf of Carlton reserved the right to argue on any appeal that the construction put forward by ISDA of the indefinite survival of the suspended payment obligations was correct.

69. Our decision on these issues in the first appeal concludes them in the second appeal so that the only remaining issue is whether the operation of Section 2(a)(iii) as we have construed it engages either the anti-deprivation principle or the operation of the *pari passu* rule of distribution. These grounds of appeal have been abandoned by the administrators in the first appeal but the judge's analysis of this issue in Firth Rixson is the basis of his decision in Carlton.

70. It is convenient at this point to refer to the convention adopted by both sides in both the first and the second appeals about the ability of the Non-defaulting Party to recover gross any payments due from the defaulting Lehman company after its entry into bankruptcy or administration. Both in this court and before the judge it was

agreed that a Non-defaulting Party who wishes to enforce the payment obligations of the Defaulting Party must give credit for what is due under its part of the swap. So in this case Carlton would not be able to prove for what LBSF was liable to pay on 2nd March 2009 by way of fixed rate interest without bringing into account its own contingent liabilities in respect of the floating rate. This agreement was not limited to the floating rate payments due on the same payment date. It also extended to any sums which but for Section 2(a)(iii) would have been payable to the Defaulting Party on an earlier date within the continuing period of default. Those liabilities would also have to be taken into account in determining the amount for which the Non-defaulting Party might prove.

71. The question whether the non-defaulting party is obliged to give credit in this way against the gross liability of the Defaulting Party remains a live issue in the Cosco appeal where netting under Section 2(c) is relied on by Pioneer as an alternative means of recovery to that provided for under Section 6 of the Master Agreement on the assumption that all of the transactions (including the eight whose expiry dates occurred before the first Event of Default) were brought into account as Terminated Transactions under the wash-out provisions. Although therefore the resolution of this issue is not relevant to the outcome of the Carlton appeal and may not be essential even in the Cosco appeal, we consider that we should summarise our views upon it at this stage if only to put our decision about anti-deprivation into context.

72. In Marine Trade SA Flaux J held that netting under Section 2(c) was not available to the Defaulting Party where the conditions precedent contained in Section 2(a)(iii) were not satisfied as of the date for payment. He confirmed this view in his judgment in Cosco. The basis of his decision was that netting under Section 2(c) applies only where the amount due from the Non-defaulting Party "would otherwise be payable". In that event the obligations of each party in respect of the same transaction "to make payment" of the fixed or floating rates are discharged and replaced by an obligation upon the party not in the money to pay the net balance due.

73. He held that "payable" connoted what he described as an immediately enforceable obligation to pay and not, as Pioneer contended, a contractual debt in respect of which the payment obligation is suspended. The judge's construction of these terms is of course consistent with his view expressed in Marine Trade that the obligation to pay on the part of the Non-defaulting Party was extinguished for all time by the non-satisfaction of the condition precedent on the relevant payment date under the Confirmation. But his construction of Section 2(c) is not dependent on that and remains arguable even if (as we have held) there is an indefinite suspension of the obligation.

74. A contrary view has been expressed by Gloster J in Pioneer Freight Futures Company Limited v TMT Asia Limited [2011] EWHC 1888 ("TMT 2") [2011] 2 Lloyd's Rep. 565 where the calculation of TMT's liability under the FFAs assumed that it was not required to give credit by way of netting under Section 2(c) for sums otherwise due from it to Pioneer during the period of default. She considered that the overall scheme of the 1992 Master Agreement was to provide for netting off of the gross liability of each party at each payment date under Section 2(c) and for a wash-out calculation of a final net figure under Section 6(e)(4) following Automatic Termination of all outstanding Transactions. This will operate retrospectively to take into account under the definition of Loss in Section 14 the parties' total losses and

gains derived from the Terminated Transactions including those payments which would have been required to be made before the Early Termination Date "assuming satisfaction of each applicable condition precedent". The calculation will also include an estimate of the prospective losses and gains of the parties consequent on the Early Termination based in part on what would have been payable prospectively over the remainder of the contract by the Non-defaulting Party again on the assumption that the conditions precedent had been satisfied.

75. Against this landscape Gloster J considered that the wording of Section 2(c) with its references to amounts that would otherwise be "payable" should be construed consistently with the commercial purpose of Section 2(a)(iii) which was to mitigate counterparty credit risk for the currency of the swap transactions. To enable the Non-defaulting Party not merely to be relieved from payment during the period of default but also to recover from the Defaulting Party its gross liabilities under the swaps as they fall due would, she said, undermine that purpose:

> "I cannot see that there is any sensible commercial justification or rationale for a construction of section 2 of ISDA 92 which enables a Non-defaulting Party to claim against a Defaulting Party on a gross basis. It appears to be wholly contrary to the ethos of ISDA 92 and clause 10(a) of the relevant FFAs, and the clear commercial purpose of the parties that all amounts outstanding under all Transactions subject to one ISDA 92 Master Agreement should be subject to automatic payment netting in respect of payments due on the same date. It emasculates the netting provisions of section 2(c) in the very circumstances where they may be most needed: namely where a Defaulting Party in the money may have to wait a long time for payment of what is owing to it (for example, until cure of its own Event of Default, or Potential Event of Default, or Early Termination), and where it may well itself be subject to cash flow constraints, or other financial pressures. On the contrary, it confers a wholly unmerited (in commercial terms) benefit on the Non-defaulting Party. Such a construction would, in my mind, fundamentally change "the financial structure of the relationship"."

76. We endorse this approach to the construction of the Section 2 obligations. The primary obligation set out in Section 2(a)(i) is that:

> "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."

77. The concluding words are unqualified and subject that primary obligation to pay to the remaining provisions of Section 2 including both Section 2(a)(iii) and Section 2(c). Although there has been some argument as to the order in which these sub-sections should be applied, the netting provisions in Section 2(c) (which are both automatic and mandatory) state in terms that they are to operate in relation to amounts which "would otherwise be payable" in the same currency and in respect of the same Transaction. The use of the words "would otherwise be payable" take account in our

view of the payment requirements specified in each Confirmation regardless of whether the conditions precedent have been satisfied as at the relevant date for payment. They are general words which qualify the terms of payment in the Confirmation ("would otherwise be payable") so as to convert each party's contractual obligations into ones to pay a net sum. The words "would otherwise" can and, in our view, should be read as the draftsman's indication that Section 2(c) operates irrespective of the terms of each payment obligation and the particular circumstances then prevailing. They are not therefore concerned with whether the amounts specified in the Confirmation have actually become payable ("are payable") on the date in question. Their purpose is to re-formulate the content of the obligations which arise as at each payment date. This can be contrasted with the definition of Unpaid Amounts in Section 14 which is concerned to capture amounts "that become payable" under the Terminated Transactions or "would have become payable but for Section 2(a)(iii)". In this context the emphasis is on what actually fell due or would have become due and payable but for the non-satisfaction of the conditions precedent. It is not concerned to re-formulate the obligations but to enforce payment under the wash-out provisions of the net payment obligations which would otherwise have operated.

78. For these reasons we consider that the construction of Section 2(c) adopted by Flaux J in Marine Trade and Cosco is wrong and that the decision of Gloster J is to be followed on this point. The convention adopted in the first and second appeals therefore accurately represents the correct operation of the Master Agreement in relation to contemporaneous payment obligations which fall due during a period of default. In the Cosco appeal a further issue arises as to whether Pioneer can net off against the sums which Pioneer owed to Cosco at the end of December 2008 the sums which would have been due to it from Cosco in the months January to March 2009 but for the operation of Section 2(a)(iii). As mentioned earlier, this point has also been conceded by the agreement made in the first and second appeals. But in relation to section 2(c) it turns on whether the earlier liabilities are sums which were payable "on the same date".

79. Mr Kimmins QC submitted that a debt which falls due on a particular date but is not then paid remains payable at all times until it is paid. This is undoubtedly true but it is not what Section 2(c) contemplates by its reference to amounts being payable "on any date" or "on the same date". It seems to us that Section 2(c) applies its netting provisions only to the amounts which, under the original terms of the contract, were expressed to be payable on the same date in respect of the same (or at the parties' election) two or more of the relevant Transactions. We shall deal later in this judgment with how (if at all) this affects the outcome of the Cosco appeal.

Anti-deprivation

80. The challenge to the operation of the Master Agreement on the grounds that it contravenes either the anti-deprivation principle or the *pari passu* rule of distribution between creditors is limited to Section 2(a)(iii). It is accepted that the close out provisions in Section 6 can produce an obligation to pay on the part of the Non-defaulting Party and take effect regardless of the occurrence of any Event of Default. As already explained, the court is also asked to consider this issue on the basis that the Defaulting Party will not be liable to pay the sums due to the Non-defaulting Party during a period of default other than on a net basis.

81. The complaint about Section 2(a)(iii) is maintained in the event of our rejection of the suggested implied term that the payment obligation should become enforceable by the Defaulting Party once the period of the contract has come to an end. Had we accepted the submission that the period of suspension was so limited no question of deprivation or of an unequal distribution of assets between creditors could have arisen because on 2nd March 2009 the final payments under the swaps would have become both due and payable. But even had the period of suspension up to the maturity date been longer the result would have been no different. LBSF (and its creditors) would have been obliged to wait for their money if the company was in the money but would not have been required to provide for more than its net liabilities if not.

82. Mr Nash does, however, pursue his arguments on this point if (as we have decided) the correct analysis of the operation of Section 2(a)(iii) is that put forward by Mr Zacaroli on behalf of ISDA. He submits that the deprivation occurred on 2nd March 2009 when but for Section 2(a)(iii) LBSF would have been entitled to a final payment from Carlton. The period of suspension may be indefinite and the only bar to recovery of this money is its supervening bankruptcy. Alternatively he submits that the operation of Section 2(a)(iii) breaches the *pari passu* rule because it suspends the recoverability (and therefore the distribution) of an asset of the bankrupt estate amongst its creditors. If this is right then questions of whether the contractual arrangements were entered into for *bona fide* commercial reasons are, he says, irrelevant. The application of the rule is mandatory: see British Eagle International Airlines Ltd v Cie Nationale Air France [1975] 1 WLR 758.

83. Belmont was concerned with a complicated set of provisions as part of which collateral in the form of investments purchased with the subscription monies for notes issued by an SPV was charged by the issuer to secure its obligations to the noteholders and to LBSF under a collateral swap agreement on terms which changed the priorities between LBSF and the noteholders in the event of the former's insolvency. Up to that time LBSF had senior ranking rights in respect of the security. The change in priority was challenged by LBSF on the ground that it deprived the company of property to which it was entitled in its bankruptcy.

84. The key provision was clause 5.5 of a supplemental trust deed which stated that:

> "The Trustee shall apply all moneys received by it under this Deed in connection with the realisation or enforcement of the Mortgaged Property as follows: Swap Counterparty Priority unless … an Event of Default (as defined in the Swap Agreement) occurs under the Swap Agreement and the Swap Counterparty is the Defaulting Party (as defined in the Swap Agreement) ... in which case Noteholder Priority shall apply."

85. The Supreme Court held that in applying the anti-deprivation rule it was necessary to look at the substance of the agreement rather than its form and to consider whether the provision in question amounted to an illegitimate attempt to evade the relevant bankruptcy law or had some legitimate commercial basis. The ratio of the decision that clause 5.5 was unobjectionable is contained in the following passage from the judgment of Lord Collins of Mapesbury which was expressly concurred in by the majority of the court:

"102. It would go well beyond the proper province of the judicial function to discard 200 years of authority, and to attempt to re-write the case law in the light of modern statutory developments. The anti-deprivation rule is too well-established to be discarded despite the detailed provisions set out in modern insolvency legislation, all of which must be taken to have been enacted against the background of the rule.

103. As has been seen, commercial sense and absence of intention to evade insolvency laws have been highly relevant factors in the application of the anti-deprivation rule. Despite statutory inroads, party autonomy is at the heart of English commercial law. Plainly there are limits to party autonomy in the field with which this appeal is concerned, not least because the interests of third party creditors will be involved. But, as Lord Neuberger stressed [2010] Ch 347, para 58, it is desirable that, so far as possible, the courts give effect to contractual terms which parties have agreed. And there is a particularly strong case for autonomy in cases of complex financial instruments such as those involved in this appeal.

104. No doubt that is why, except in the case of a blatant attempt to deprive a party of property in the event of liquidation (*Folgate London Market Ltd v Chaucer Insurance plc* [2011] EWCA Civ 328), the modern tendency has been to uphold commercially justifiable contractual provisions which have been said to offend the anti-deprivation rule: *Money Markets International Stockbrokers Ltd v London Stock Exchange Ltd* [2002] 1 WLR 1150; *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch); and the judgments of Sir Andrew Morritt C and the Court of Appeal in these proceedings. The policy behind the anti-deprivation rule is clear, that the parties cannot, on bankruptcy, deprive the bankrupt of property which would otherwise be available for creditors. It is possible to give that policy a common sense application which prevents its application to bona fide commercial transactions which do not have as their predominant purpose, or one of their main purposes, the deprivation of the property of one of the parties on bankruptcy.

105. Except in the case of well-established categories such as leases and licences, it is the substance rather than the form which should be determinant. Nor does the fact that the provision for divestment has been in the documentation from the beginning give the answer, nor that the rights in property in question terminate on bankruptcy, as opposed to being divested. Nor can the answer be found in categorising or characterising the property as "property subject to divestment on bankruptcy."

> 106. If the anti-deprivation principle is essentially directed to intentional or inevitable evasion of the principle that the debtor's property is part of the insolvent estate, and is applied in a commercially sensitive manner, taking into account the policy of party autonomy and the upholding of proper commercial bargains, these conclusions on the present appeal follow.
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> 107. The answer is not to be found in the Noteholders' argument that (a) LBSF's property was a beneficial interest under a trust, of which it was one of a number of beneficiaries (Clause 5.3 of the STD) and that (b) LBSF retains its beneficial interest under the trust to this day. The fact that the security interests were held by the Trustee is not determinative. The court has to look to the substance of the matter, which is that LBSF had a security interest, the content and extent of which altered when it filed for Chapter 11 protection. Nor is it to be found in the fact that the potential for change in priority was in the documentation from the beginning, nor in the "flawed asset" argument or variant of it, that the security interest, or the right under the trust to have the trust property administered in accordance with Swap Counterparty Priority, was inherently qualified or limited, because it applied only for so long as there had been no Event of Default under the Swap Agreement for which the Swap Counterparty was the Defaulting Party.
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> 108. The answer is to be found in the fact that this was a complex commercial transaction entered into in good faith. Although, as a matter of law, the security was provided by the Issuer out of funds raised from the Noteholders, the substance of the matter is that the security was provided by the Noteholders and subject to a potential change in priorities.
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> 109. The security was in commercial reality provided by the Noteholders to secure what was in substance their own liability, but subject to terms, including the provisions for Noteholder Priority and Swap Counterparty Priority, in a complex commercial transaction entered into in good faith. There has never been any suggestion that those provisions were deliberately intended to evade insolvency law. That is obvious in any event from the wide range of non-insolvency circumstances capable of constituting an Event of Default under the Swap Agreement."

86. This must now be taken as an authoritative statement of the anti-deprivation principle. The court in Belmont rejected the approach suggested by Patten LJ in the Court of Appeal based on what Lord Collins describes as the flawed asset theory preferring instead to consider each transaction on its merits to see whether the shift in interests complained of could be justified as a genuine and justifiable commercial response to the consequences of insolvency.

87. If this is the touchstone then it is difficult to see how Section 2(a)(iii) of the Master Agreement can be said to offend against the anti-deprivation principle. The suspension of the payment obligations of the non-defaulting party for the duration of the insolvency does no more than to prevent Carlton from having to make payments under a hedging arrangement with a bankrupt counterparty. There is no suggestion that it was formulated in order to avoid the effect of any insolvency law or to give the non-defaulting party a greater or disproportionate return as a creditor of the bankrupt estate. Mr Nash placed some emphasis on the fact that the payment in question fell due at the end of the contract period but this is irrelevant in our opinion to the application of the anti-deprivation principle. The commerciality of the arrangements has to be judged by considering the operation of Section 2(a)(iii) throughout the life of the contract and not solely by reference to the point in time when it comes to operate.

88. Looked at in this way it cannot be said that the suspensory effect of Section 2(a)(iii) engages the anti-deprivation principle. In Firth Rixson Briggs J suggested that a useful test for determining whether the creation *ab initio* of a flaw in an asset amounted to a breach of the anti-deprivation principle when the condition of insolvency was fulfilled might be to ask whether the chose in action represents the *quid pro quo* for something already done, sold or delivered prior to the event of insolvency or is intended to provide the *quid pro quo* for services yet to be rendered:

> "108. In my judgment the critical distinction which emerges from those and other cases may be expressed in the following way. Where the asset of the insolvent company is a chose in action representing the quid pro quo for something already done, sold or delivered before the onset of insolvency, then the court will be slow to permit the insertion, even ab initio, of a flaw in that asset triggered by the insolvency process. By contrast, where the right in question consists of the quid pro quo (in whole or in part) for services yet to be to be rendered or something still to be supplied by the insolvent company in an ongoing contract, then the court will readily permit the insertion, ab initio, of such a flaw, there being nothing contrary to insolvency law in permitting a party either to terminate or adjust what would otherwise be an ongoing relationship with the insolvent company, at the point when it goes into an insolvency process.
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> 109. Examples of the former type are the royalty stream in *Ex p Mackay*, which was the quid pro quo for a patent sold outright by the person who later became bankrupt, and the debt owed by Air France to British Eagle, which was for services already rendered by British Eagle to Air France prior to the commencement of its winding up.
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> 110. Familiar examples of the latter category are leases and licences, where the right to enjoy the underlying asset accrues over time, in exchange, also over time, for payment of rent or fees, and which have always been terminable on bankruptcy without infringing the rule: see the *Perpetual Trustee Co* case

> [2010] 1 BCLC 747 at [64]. A more telling example is the security right enjoyed by LBSF under its swap agreement in priority to the noteholders over collateral for which the noteholders had paid the price, and which was liable to be subordinated to the noteholders' security in the event of LBSF's insolvency. That right was conferred in connection with a swap contract also governed by an ISDA master agreement, pursuant to which LBSF had ongoing obligations at the time when it went into Chapter 11 bankruptcy."

89. In Belmont Lord Walker (at para 131) described this as a valuable contribution to the search for principle although as a test it lacked precision. Lord Mance was more emphatic:

> "176. I would accept that the forfeiture of contractual rights on the bankruptcy of the party enjoying them is in some circumstances capable of constituting a deprivation of property within the principle precluding evasion of the bankruptcy law. This is so not only with accrued rights, but may also be the case with other rights, as, for example, where the bankrupt has performed his part before going bankrupt or the right can fairly be treated as independent of any as yet unperformed obligation. I question, even at common law, whether an insured who enjoys third party liability cover for a period on a claims made basis and goes bankrupt part way through that period could properly be deprived of the benefit of such cover in respect of claims arising from his activities prior to his bankruptcy. To that extent, s 1(3) of the Third Parties (Rights against Insurers) Act 1930 may well have done no more than reflect what would have been held to be the common law.
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> 177. However, Mr Snowden advanced propositions which would mean that any provision for termination on bankruptcy, which would deprive the trustee or liquidator of the opportunity of continuing the contract and so the bankrupt estate of future potential advantage, would infringe the principle. There is in my opinion no basis for any such rule. Where a contract provides for the performance in the future of reciprocal obligations, the performance of each of which is the quid pro quo of the other, I see nothing objectionable or evasive about a provision entitling one party to terminate if the other becomes bankrupt. That is particularly so, having regard to the purpose and character of the present transaction, viewed rather more broadly than the Court of Appeal did in its detailed reasoning.
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> …..
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> 179. I see no reason therefore why the law should preclude a commercial party in the position of Saphir (acting for the benefit of Noteholders) from insisting that it would only provide the desired cover so long as LBSF was able, whatever

> the predicted outcome of the transaction, to perform its part in full. The purpose and effect of such a provision is not to evade the bankruptcy law. It is to protect the natural interest of any contracting party, and particularly someone who is providing in effect credit insurance, that it should not find itself having to perform to its disadvantage, without being able to enforce performance if this would be to its advantage. It is a prudent limitation on the duration and operation of the contract. The result reached by Briggs J in *Lomas v JFB Firth Rixson Inc* was correct in relation to the mutual contractual obligations with which he was concerned."

90. Lord Collins (at paras 100-101) declined to express a concluded view about the application of the principle to payment obligations under executory contracts other than to note that accrued property rights such as debts must at least be capable of being caught by the rule. But, as already mentioned, there is no suggestion that Section 2(a)(iii) can affect the recovery of sums which became due and payable before the Event of Default.

91. It seems to us that the application of the anti-deprivation principle to contracts of this kind has to be considered on a case specific basis in which the factors suggested by the judge will be relevant as one means of distinguishing between a commercial re-arrangement of rights to reflect the economic consequences of insolvency and an attempt to pre-empt the distribution of assets in a bankrupt estate. Mr Nash submits that there is no commercial justification for the consequences of Section 2(a)(iii) even when it occurs near the outset of the contract period. Its effect is to allow the non-defaulting party to keep the contract open with no obligation to make further payments whereas the defaulting party is kept on risk and cannot close the transaction.

92. We are not persuaded by this. The purpose of Section 2(a)(iii) is to protect the non-defaulting party from the additional credit risk involved in performing its own obligations whilst the defaulting counterparty remains unable to meet its own. The liabilities of the defaulting party are capped (as we have held) under Section 2(c) so that during a period when that party is in the money it will have no exposure and when it is out of the money its liabilities will be net of any countervailing credits which would have fallen due from the non-defaulting party. The fact that the defaulting party is unable to terminate the transaction and so recover what is due to it on a close-out is simply the product of the balance struck between the interests of the non-defaulting party which would otherwise have to pay its net liabilities in full under a non-performing contract and those of the defaulting party whose own net liabilities will take the form at best of a dividend in the liquidation or administration. The indefinite suspension of the payment obligation of the non-defaulting party (like any attempt to balance competing interests) may on one view be criticised as imperfect but it cannot be said to be uncommercial.

93. There is, however, another reason why we consider that an argument based on the anti-deprivation principle cannot succeed in this case. This is simply that the deprivation of which LBSF complains was as much attributable to the bankruptcy of LBHI (the Credit Support Provider) which took place on 15th September 2008 some three weeks before that of LBSF as it was to that of LBSF. As of 2nd March 2009 when the final payment fell due there was therefore a continuing Event of Default

which prevented the satisfaction of the condition set out in Section 2(a)(iii)(1) regardless of the position of LBSF and which operated to the same effect.

94. In these circumstances the anti-deprivation rule cannot protect LBSF from the contractual consequences of its own insolvency.

95. In anticipation of some of those difficulties Mr Nash submitted in the alternative (and as the preferred basis of his argument) that this was in fact a case where Section 2(a)(iii) had the effect of breaching the *pari passu* rule of distribution. The advantage of this argument (if correct) is that the rule (which is given statutory effect in ss. 107 and 328 of the Insolvency Act 1986) applies almost without qualification to any property of the bankrupt estate and does not depend for its application on questions of commerciality and good faith: see Belmont at paragraph 75.

96. The relationship between the anti-deprivation principle and the *pari passu* rule is both dependant and autonomous. The former is concerned with contractual arrangements which have the effect of depriving the bankrupt estate of property which would otherwise have formed part of it. The *pari passu* rule governs the distribution of assets within the estate following the event of bankruptcy. It therefore invalidates arrangements under which a creditor receives more than his proper share of the available assets or where (as in British Eagle) debts due to the company on liquidation were to be dealt with other than in accordance with the statutory regime.

97. The anti-deprivation principle therefore protects the value of the estate from attempts to evade the insolvency laws and, as a consequence, facilitates the application of the *pari passu* rule. But their areas of operation are distinct and it is clear that the *pari passu* rule is only engaged in respect of assets of the estate as at the commencement of the bankruptcy or liquidation. This was why in British Eagle the decisive issue was whether a debt was owed to the company when the resolution for voluntary liquidation was passed.

98. In this case there was no debt payable to LBSF when its bankruptcy commenced. The obligation to pay was subject to a condition precedent that there should be no continuing Event of Default. In the event there were at least two. It follows that Section 2(a)(iii) does not infringe the *pari passu* rule because it operates at most to prevent the relevant debt ever becoming payable. There is therefore no property which is capable of being distributed.

99. LBSF also has the difficulty that Carlton is not a creditor in respect of the final payment which became due on 2nd March 2009. Although we can see how an attempt by a debtor to resist payment (as in British Eagle) by relying on contractual arrangements which offend against the *pari passu* rule could be defeated by the application of that rule, the circumstances are likely to be unusual. In most cases the *pari passu* rule will be relied on by the liquidator or trustee in bankruptcy to defeat a creditor's reliance on a contractual arrangement which was intended to give him preference in relation to the distribution of the estate. In this case no question of any distribution arises and Carlton's status as a debtor merely serves to confirm that the issue between the parties is not how the £2.65m which fell due on 2nd March should be distributed but whether it is payable at all.

Conclusions on the second appeal

100. We will therefore dismiss the second appeal.

The facts of the Third Appeal

101. The third appeal (Pioneer Freight Futures Company Limited (in liquidation) v Cosco Bulk Carrier Company Limited) concerns a series of eleven FFAs entered into by Pioneer and Cosco between January 2007 and August 2008. All were subject to the 2007 terms of the Forward Freight Agreement Brokers Association which incorporate by reference the Master Agreement.

102. For convenience the contracts have been sub-divided into three groups. The groups do not follow the order in which the contracts were entered into. The first four contracts, nos 1-4, under which Cosco was seller, called for, variously, performance in the Contract Months January to December 2008. The second four contracts, nos 5-8, under which Pioneer was seller, called for, variously, performance in the Contract Months January 2008 to March 2009. The final three contracts, nos 9, 10 and 11, under which Pioneer was again seller, called for, variously performance in the Contract Months January 2007 to December 2009.

103. Under the contracts the Settlement Date was the last Baltic Exchange Index publication day of each Contract Month. That is significant because on 14 December 2009 Pioneer passed a resolution for its winding-up. It is common ground that this was an Event of Default under the Master Agreement, the effect of which was to bring about the AET of all outstanding transactions between the parties under the Master Agreement.

104. Seven of the eleven FFAs had October 2008 as a Contract Month. Under four of these, Cosco was the seller and payment was due from Pioneer in an amount of US$ 9,220,955.64. Under the other three of these seven contracts Pioneer was the seller and payment was due from Cosco of US$ 2,544,992.42. With netting, this meant that a balance in favour of Cosco of US$ 6,478,003.22 was due (pursuant to clause 8 of each FFA) on 7 November 2008. Although Pioneer accepts that such sum was due to Cosco, it did not pay it or any part of it.

105. On 11 November 2008 Cosco wrote to Pioneer giving notice of failure to pay this sum and stating that, if Pioneer failed to pay the sum on or before the third business day after receiving the letter, that failure would constitute an Event of Default under sections 5(a)(i) and 5(a)(v)(2) of the Master Agreement. The letter also stated that, by virtue of Section 2(a)(iii), Cosco would have no obligation to make any payment in respect of any of the FFAs for so long as such Event of Default was continuing.

106. Pioneer did not pay the sum due within that timescale or at all and it is common ground that there was an Event of Default, or Potential Event of Default, following Pioneer's failure to make that payment and that, by virtue of Section 2(a)(iii), Cosco was not obliged to make any payment falling due to Pioneer in future Contract Months during the currency of the Master Agreement while Pioneer's failure to pay had not been cured.

107. In fact neither party made any further payment under any of the FFAs, and this remained the position until Pioneer went into liquidation in December 2009.

108. The accounting position between the parties as at the end of December 2009 was as follows:-

(1) It is accepted for present purposes that under FFAs nos 1-4 Cosco remained the party in the money until the establishment of the amount due in respect of the last Contract Month under each contract, December 2008. It is accepted that a sum of about US$ 29M is payable by Pioneer to Cosco in respect of these four transactions. That liability has accrued due and Pioneer does not dispute it, although it has not paid it. The parties have left over for further determination whether the figure of US$ 29M in fact requires some slight revision for reasons not relevant to the appeal.

(2) Under FFAs nos 5 and 6 the last Contract Month was also December 2008. For FFAs nos 7 and 8 the last Contract Month was March 2009. It is common ground that but for the application of Section 2(a)(iii) of Master Agreement the total sum of about US$ 23M would have been due from Cosco to Pioneer under these four FFAs.

(3) Under FFAs 9, 10 and 11 Pioneer was again in the money. The last Contract Month was December 2009 so that the last Settlement Date fell after AET had been brought about on 14 December 2009. It is common ground that these three transactions were in consequence subject to the AET provisions and that as a result of the close-out netting procedure a sum of about US$ 22M is due from Cosco to Pioneer in respect of them.

109. In point of form the dispute between the parties concerns the status of FFAs nos 1-8 and whether in particular they too were subject to AET in December 2009. If they were, the effect of applying the close-out provisions in Section 6 of the Master Agreement and the choice by the parties of Second Method and Loss would result in a balance due to Pioneer of a little over US$ 16M, being, broadly, the result of deducting from the US$ 45M due from Cosco to Pioneer under FFAs nos 5-11 the US$ 29M due from Pioneer to Cosco under FFAs nos 1-4.

110. Pioneer contends that all eleven of the FFAs were indeed subject to AET in December 2009. Cosco contends that FFAs nos 1-8 were not subject to AET because in each case the last date for performance had passed prior to the Early Termination Date.

111. Flaux J agreed with Cosco. He held that any unperformed obligation under such a Transaction, including obligations that had accrued due to Cosco but had not been paid by Pioneer, and obligations that would have accrued due to Pioneer but for the operation of Section 2(a)(iii) upon Pioneer becoming subject to an Event of Default, were not to be taken into account in arriving at the net sum payable under Section 6(e).

112. In point of substance Flaux J's conclusion only affects the treatment of FFAs nos 5-8, because notwithstanding he held that FFAs nos 1-4 were not subject to the AET procedure, he nonetheless held that there remained an accrued debt due to Cosco

thereunder which Cosco could set off against the sum calculated under Section 6(e) as due under FFAs nos 9, 10 and 11.

113. Pioneer argued before Flaux J that it could in the alternative achieve a result not much less advantageous to it by a simple application of the netting provisions contained in Section 2(c) of Master Agreement. We have already referred to this at paragraphs 71-78 above. We have indicated there our view that Flaux J's approach to this point was wrong. But that will not avail Pioneer since we have also concluded, as indicated at paragraphs 78 and 79 above, that Section 2(c) applies its netting provisions only in relation to contemporaneous payment obligations, that is to say only to amounts which, under the original terms of the contract, were expressed to be payable on the same date in respect of the same (or at the parties' election) two or more of the relevant transactions. Pioneer cannot therefore utilise Section 2(c) to net off against the sums which it owed Cosco at the end of December 2008 the sums which would, but for the operation of Section 2(a)(iii), have fallen due from Cosco to Pioneer in the months January, February and March 2009.

114. However, in our judgment, Pioneer has no need of this alternative argument. It follows from our conclusions expressed in paragraphs 21-63 above that the view to which Flaux J came concerning the ambit of close-out netting pursuant to Section 6(e) of Master Agreement consequent upon AET taking effect on 14 December 2009 is necessarily wrong. All eleven FFAs were in our view subject to AET, there being no basis for excluding from its ambit transactions in respect of which the last date for performance had passed prior to AET taking effect.

115. Flaux J concluded that the close-out netting calculation under Section 6(e) excluded Transactions "which have already terminated at their natural expiry date" – see paragraph 103 of his judgment at [2011] EWHC 1692 (Comm). Thus Cosco's suspended obligation to pay Pioneer under FFAs nos 5-8 was extinguished because the Event of Default subsisted on the final date for performance of obligations thereunder. Even Pioneer's accrued obligation to pay Cosco under FFAs nos 1-4 was not subject to the close-out calculation because those Transactions had "expired by effluxion of time".

116. These reasons are obviously inconsistent with and unsustainable in the light of our conclusions that:-

i) The underlying debt obligation under Section 2(a)(i) is undisturbed by the Event of Default. It is the payment obligation alone which is suspended.

ii) A Non-defaulting Party's obligation to pay under Section 2(a)(i) is not extinguished merely because an Event of Default exists on the date specified in the contract for performance.

iii) The payment obligation is not extinguished on the maturity of the Transaction, by which we mean the arrival of the last date fixed for contractual performance. The terms of the Master Agreement recognise no concept of expiry by effluxion of time, nor is there any basis upon which it can arise by implication.

iv) It is possible for the Non-defaulting Party to terminate early after the maturity date of the Transaction. A fortiori, Automatic Early Termination can take place after the maturity date of the transaction where AET has been specified in the Schedule as provided in Section 6(a) of Master Agreement.

117. That is sufficient to dispose of the third appeal. Flaux J considered that his conclusion was supported by one or two linguistic points, but his conclusion was essentially dependent upon his flawed analysis that the Transaction "expired by effluxion of time", as was his approach to the contractual language. It suffices to say that, properly understood in the context of the shape and nature of the transactions as we have determined them to be, neither the phrase "all outstanding Transactions" in Section 6(a) nor the phrase "all Transactions in effect" in the definition of Terminated Transactions used in Section 6(e)(ii) carries any implication that Transactions in respect of which the last date specified for performance has passed are excluded from the close-out mechanism following Early Termination.

118. We also agree with Mr Kimmins and Mr Zacaroli that Flaux J's approach is inconsistent with the "Single Agreement" provision in Section 1(c) of the Master Agreement. That provides:-

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

The effect of Section 1(c) is that the parties are agreeing that the obligations contained in "all Transactions . . . entered into" (emphasis added) are not to be treated as separate and distinct, but are made subject to the contractual framework constituted by the Master Agreement, including when an Early Termination Date occurs. This is reinforced and emphasised by the statement that "the parties would not otherwise enter into any Transactions" (emphasis added). On the approach adopted by Flaux J all Transactions are not treated in the same way but are treated differently, some being made part of close-out netting and others being excluded. Mr Zacaroli submitted that the concept of the Single Agreement is one of the main pillars on which the ISDA Master Agreement architecture is built. We can understand why that may be so, and we agree with Mr Zacaroli that there is no basis for any implied limitation on the categories of Transaction intended to comprise the Single Agreement.

119. Flaux J derived linguistic support for his conclusion from the circumstance that the final sentence of Section 6(e) of ISDA provides:-

> "The amount, if any, payable in respect of an Early Termination Date and determined pursuant to this Section will be subject to any set-off."

Set-off is a defined term. Section 14 provides that it means:-

> "Set-off, offset, combination of accounts, right of retention or withholding or similar right or requirement to which the payer

> of an amount under Section 6 is entitled or subject (whether arising under this Agreement, another contract, applicable law or otherwise) that is exercised by, or imposed on such payer."

Flaux J considered that this demonstrated that the wording of the Master Agreement expressly recognises that there may be sums owing under the Master Agreement which are not the subject of close-out netting. The paradigm case is likely we think to be a Set-off of a right to payment under another agreement. We are unsure why the draftsman included reference to a right of Set-off to which the payer of an amount under Section 6 is entitled or subject "arising under this Agreement" but whatever his purpose, which may simply have been an abundance of caution, it is a wholly insubstantial basis upon which to displace our clear conclusion that the shape and nature of the Master Agreement necessarily involves the result that the obligations arising under all eleven of the FFAs were here subject to close-out netting.

Conclusions on the Third Appeal

120. We will therefore allow the third appeal. Subject to the point reserved, Pioneer is entitled to US$ 16,554,061.69 together with interest. Again, we shall ask the parties to co-operate in drawing up a new order.

The Facts of the Fourth Appeal

121. The fourth appeal, wherein Bulk Trading SA ("Bulk") is Appellant and Britannia Bulk plc (in liquidation) ("Britannia Bulk") is Respondent, again concerns a forward freight agreement on the FFABA 2007 Terms incorporating by reference the Master Agreement. The contract in question was made on 24 June 2008 between Britannia Bulk as seller and Bulk as buyer. The details do not matter, save only that (1) the performance months were January – December 2009, (2) for the purposes of payment on Early Termination the parties had selected Loss as the payment measure and Second Method as the payment method and (3) the parties had agreed that Automatic Early Termination would apply to both parties.

122. Administrators were appointed over Britannia Bulk on 31 October 2008. It is now in liquidation. By virtue of Section 5(a)(vii)(6) and section 6(a) of the Master Agreement AET took place immediately upon appointment of administrators. That brought into play the regime prescribed by Section 6(e) for Payments on Early Termination. That regime is summarised at paragraph 8(xiii) above. The fourth appeal raises the point to which that description is there made subject, whether in all circumstances the Master Agreement requires it to be assumed for the purpose of carrying out the relevant calculations that each applicable condition precedent has been satisfied.

123. Section 6(e)(i)(4) of the Master Agreement provides:-

> "*Second Method and Loss.* If the Second Method and Loss apply, an amount will be payable equal to the Non-defaulting Party's Loss in respect of this Agreement. If that amount is a positive number, the Defaulting party will pay it to the Non-defaulting Party; if it is a negative number, the Non-defaulting

> Party will pay the absolute value of that amount to the Defaulting Party."

Loss is defined in Section 14. Since the argument turns in part on whether the Loss and Market Quotation methods are intended to achieve essentially similar outcomes we set out as well the definition of the latter which appears in Section 14 immediately after the definition of "Loss".

> ""**Loss**" means, with respect to this Agreement or one or more Terminated Transactions, as the case may be, and a party, the Termination Currency Equivalent of an amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be, including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or related trading position (or any gain resulting from any of them). Loss includes losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made, except, so as to avoid duplication if Section 6(e)(i)(1) or (3) or 6(e)(ii)(2)(A) applies. Loss does not include a party's legal fees and out-of-pocket expenses referred to under Section 11. A party will determine its Loss as of the relevant Early Termination Date, or, if that is not reasonably practicable, as of the earliest date thereafter as is reasonably practicable. A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets.
>
> "**Market Quotation**" means, with respect to one or more Terminated Transactions and a party making the determination, an amount determined on the basis of quotations from Reference Market-makers. Each quotation will be for an amount, if any, that would be paid to such party (expressed as a negative number) or by such party (expressed as a positive number) in consideration of an agreement between such party taking into account any existing Credit Support Document with respect to the obligations of such party) and the quoting Reference Market-maker to enter into a transaction (the "Replacement Transaction") that would have the effect of preserving for such party the economic equivalent of any payment or delivery (whether the underlying obligation was absolute or contingent and assuming the satisfaction of each applicable condition precedent) by the parties under Section "2(a)(i) in respect of such Terminated transaction or group of Terminated transactions that would, but for the occurrence of

> the relevant Early Termination Date, have been required after that date. For this purpose, Unpaid Amounts in respect of the Terminated Transaction or group of Terminated Transactions are to be excluded but, without limitation, any payment or delivery that would, but for the relevant Early termination Date, have been required (assuming satisfaction of each applicable condition precedent) after that Early Termination Date is to be included. The Replacement Transaction would be subject to such documentation as such party and the Reference Market-maker may, in good faith, agree. The party making the determination (or its agent) will request each Reference Market-maker to provide its quotation to the extent reasonably practicable as of the same day and time (without regard to different time zones) on or as soon as reasonably practicable after the relevant Early Termination Date. The day and time as of which those quotations are to be obtained will be selected in good faith by the party obliged to make a determination under Section 6(e), and, if each party is so obliged, after consultation with the other. If more than three quotations are provided, the Market Quotation will be the arithmetic mean of the quotations, without regard to the quotations having the highest and lowest values. If exactly three such quotations are provided, the Market Quotation will be the quotation remaining after disregarding the highest and lowest quotations. For this purpose, if more than one quotation has the same highest value or lowest value, then one of such quotations shall be disregarded. If fewer than three quotations are provided, it will be deemed that the Market Quotation in respect of such Terminated Transaction or group of Terminated Transactions cannot be determined."

124. AET required Bulk as the Non-defaulting Party reasonably to determine in good faith its total loss or gain from the terminated contract. It will be noted that in the second sentence of the definition of Loss, which deals with payments required to have been made on or before the relevant Early Termination Date, of which there were of course none here, an assumption is required that each applicable condition precedent had in fact been satisfied. The same assumption is required when making the quotation prescribed by the definition of Market Quotation. This assumption is not mentioned in the first sentence of the definition of Loss.

125. It is common ground that, had the Event of Default not occurred and the agreement been performed throughout its currency then, on the basis of the forward freight rates available on 31 October 2008, Bulk would have been liable to pay Britannia Bulk substantial sums over the term of the contract. Britannia Bulk says that, because early termination has relieved Bulk of that liability, Bulk has made a gain in respect of which it must make a payment to Britannia Bulk.

126. Bulk, by contrast, says that it has made no gain since, had the early termination not occurred, no payments would have accrued due to Britannia Bulk over the term of the agreement because for the whole of the term Britannia Bulk would have remained

affected by bankruptcy and so the condition precedent to payment in Section 2(a)(iii)(1) would not have been fulfilled. Since nothing would have been payable had the contract continued, there is no gain for which Bulk must account.

127. Thus the question may be formulated – is Bulk as the Non-defaulting Party obliged to calculate its loss by reference to sums which would have become due to Britannia Bulk had Britannia Bulk not remained subject to an Event of Default after Automatic Early Termination? Bulk's argument is that it is not so obliged. It points to the omission from the first sentence of the definition of Loss, which is a forward not backward looking provision, of the requirement to make the assumption that each applicable condition precedent has been satisfied.

128. Bulk's argument was rejected by Flaux J in his judgment in this case [2011] EWHC 692 (Comm). [2011] 2 Lloyd's Rep 84 Gloster J came to the same conclusion in a judgment delivered one week later – see Pioneer Freight Futures Company Limited (in liquidation) v TMT Asia Limited [2011] 2 Lloyd's Law Rep 96 at paragraphs 109-117.

129. In a subsequent decision, Anthracite Rated Investments (Jersey) Ltd v Lehman Brothers Finance SA (in liquidation)[2011] 2 Lloyd's Law Rep 538, Briggs J said this at paragraph 116 of his judgment:-

> "A significant body of recent case law has developed in relation to the interpretation and application both of Loss and Market Quotation under the 1992 Master Agreement. The decisions to which I was referred are *Australia and New Zealand Banking Group Ltd v Société Générale* [2000] CLC 833; [2000] 1 All ER (Comm) 682; *Peregrine Fixed Income Ltd (In Liquidation) v Robinson Department Store plc* [2000] CLC 1328; *Britannia Bulk plc (In Liquidation) v Pioneer Navigation Ltd* [2011] 2 Lloyd's Rep 84; and *Pioneer Freight Futures Co Ltd v TMT Asia Ltd* [2011] 2 Lloyd's Rep 96. Those authorities establish the following broad propositions:
>
> (1) Loss and Market Quotation are, although different formulae, aimed at achieving broadly the same result, so that the outcomes derived from one may be usefully tested by way of cross-check by reference to the other: see per Mance LJ in the *Australia* case at paras 2, 15 and 22. This derived from a concession in that case, but has subsequently been reaffirmed after adversarial argument in the *Peregrine* case at para 30, in the *Britannia Bulk* case at paras 44 to 46 and 51, and in the *Pioneer* case at paras 98 and 105. It is one of those sensible concessions which as hardened into hornbook law.
>
> (2) The identification of the Non-defaulting Party's loss of bargain arising from the termination of the Derivative Transaction requires a "clean" rather than "dirty" market valuation of the lost transaction.

> This means that the loss of bargain must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion, and that all conditions to its full performance by both sides would have been satisfied, however improbable that assumption may be in the real world: see in the *Australia* case at paras 5, 22 to 27 and 30 to 31, the *Britannia Bulk* case at paras 11 to 14 and 34 to 35, and in the *Pioneer* case at paras 112 to 117.
>
> (3) The termination payment formulae under section 6(e) are not to be equated with, or interpreted rigidly in accordance with the quantification of damages at common law for breach of contract. They are methods of calculating close-out positions on the termination of a derivative transaction or series of transactions: see the *Britannia Bulk* case per Flaux J at para 37. This is, in particular, because the Second Method works both ways, and may lead to a close-out payment due to the Defaulting Party."

130. The *Australia* case was, as is apparent, a decision of the Court of Appeal, Kennedy and Mance LJJ. The *Peregrine* case was a decision of Moore-Bick J, as he then was.

131. We agree with Briggs J's analysis of the effect of these cases. Mr Zacaroli for ISDA contended that on this point Flaux J (and Gloster J) had reached the correct conclusion. Faced with this unanimity of approach we would hesitate long before reaching a contrary view. We were not persuaded by Mr Willan for Bulk that we should.

132. It seems to us that Flaux J was right to say, at paragraphs 13 and 35 of his judgment, that Bulk's argument is founded upon a fallacy or an impossibility. Where AET applies, as here, there cannot be a relevant Bankruptcy Event of Default without there being AET in consequence. Bulk's argument assumes an Event of Default going forward for the remainder (or here the whole) of the contract period, but that is not possible, since such Event of Default would itself lead to AET. So one cannot posit a contract going ahead in circumstances where Britannia Bulk is in administration. Thus as Flaux J pointed out at paragraph 35 of his judgment:-

> ". . . Although it is right that the first sentence of the Loss definition does not say in terms "assuming satisfaction of all conditions precedent", it does not need to, because that is the only basis upon which the assessment of the "gain" can proceed, namely on the basis that there was no Bankruptcy Event of Default and thus no Automatic Early Termination. The gain in connection with the contract being terminated on that basis is indeed the amount of the payments which [Bulk] would have been required to make over the remaining term of the contracts."

133. Gloster J made a slightly different but in our view equally compelling point at paragraph 116 of her judgment in Pioneer v TMT. Dealing with exactly the same arguments as were addressed both to Flaux J and in turn to us, she said this, at page 116 of the report:-

> "Fourth, as was submitted by Mr Kimmins and also by leading counsel for the Defaulting Party in *Britannia*, there is logically no need for the first sentence of the Loss definition in section 14 (relating to composite losses or gains, including loss of bargain) expressly to include the provision "assuming satisfaction of each applicable condition precedent". That is because that assumption is the only basis upon which a "gain" would ever have to be given credit for by the Non-defaulting Party under the Second Method. If Mr Crow were right, the Non-defaulting Party would never have to pay anything in respect of loss of bargain going forward. But the concept of Loss (including a non-defaulting Party's gain), as defined in section 14, clearly envisages that the Non-defaulting Party may have to pay the Defaulting Party something on "wash out" under section 6(e)(i)(4) in respect of loss of bargain. Given that the definition of "Loss" is not equivalent to the common law measure of damages, but rather is a method of calculating close out positions irrespective of which is the party in breach, I see no commercial basis for the position for which Mr Crow contends. In this respect I respectfully concur with the approach adopted by Flaux J in *Britannia* on this point."

134. We agree with this analysis. Indeed, we can see no answer to it.

135. Mr Willan submitted that the short question is what is meant by the words "total losses and costs or gain . . . including any loss of bargain" as used in the first sentence of the definition of Loss. He submitted that these words indicated an intention that "real" losses or gains should be looked at, not the nominal value of the obligations ignoring the reality of what had occurred. The judge had, he submitted, fallen into error in starting from the assumption that the words are concerned to describe a wash-out or close-out situation. It is, he submitted, inimical to the structure of the agreement that the Non-defaulting Party should have to pay to the Defaulting Party where, if the situation were reversed so that it was the Non-defaulting Party in the money rather than the Defaulting Party, the Non-defaulting Party could expect no payment from the Defaulting Party.

136. Attractively though these submissions were advanced, we consider that it is they which are in error rather than the judge's approach. The words the meaning of which must be construed appear in the definition of Loss which is itself a concept introduced in Section 6(e) of the Master Agreement, which section is concerned with wash-out or close-out netting. As Gloster J pointed out in Pioneer v TMT, the definition of Loss is a method of calculating close-out positions irrespective of which party is in breach and it does not nor is it intended to produce a result equivalent to the common law measure of damages. Despite the weight of the learning against him on this point, Mr Willan did not accept that the two methods, Loss and Market Quotation, were intended to achieve broadly similar results, but it would as it seems to us be very odd

if they were intended to achieve radically different results. Both set out to assess the loss of bargain going forwards and it would we think be a surprising result if they required the making of fundamentally different assumptions as to the prospective satisfaction of conditions precedent which will inevitably lead to radically different outcomes. It was the choice of the parties that a relevant Bankruptcy Event of Default should lead to Automatic Early Termination. The result for which Mr Willan contends is that which would have obtained had the parties not so chosen in their contract and had Bulk elected not to exercise its right to terminate upon the occurrence of an Event of Default. Section 6(a) of the Master Agreement makes express provision for the selection of AET in respect of certain of the Bankruptcy Events of Default enumerated in Section 5(a)(vii). In these circumstances, it is impossible to regard the result achieved as inimical to the structure of the agreement. The structure of the agreement is such that the result contended for by Bulk could have been but was not chosen by the parties as a possible outcome.

Conclusions on the Fourth Appeal

137. We will therefore dismiss the fourth appeal.