IASB/FASB Meeting September 2010

IASB Agenda reference	**8D**
FASB Agenda reference	**6**

Staff Paper

Project	**Balance Sheet - Offsetting**
Topic	**Legal Enforceability**

Purpose

1. Primarily, the purpose of this memorandum is to discuss issues related to the legal enforceability of the right of set off pursuant to ISDA Master Netting Agreements. Secondarily, the purpose of this memorandum is to discuss the existence of other situations where financial institutions have the right of set off (e.g., a loan agreement that contains a provision to set off the loan against deposits held by the borrower at the financial institution).

2. This is in response to a request by some Board members at the June 2010 joint meeting. The board members requested that the staff obtain more information on, among other things, the legal enforceability of the offsetting provisions in (ISDA) and other similar master netting agreements.

Summary of Staff Conclusions

3. After considerable research and outreach by the staff, the staff do not agree on the primary question of legal enforceability. Some staff believe that the enforceability of the ISDA master netting arrangements are questionable, thus, should not be included in the criteria for offsetting while others understand that the relevant key provision regarding the non-defaulting parties right to elect to close out net is legally

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enforceable and that the concept of a legally enforceable right to offset should be considered for inclusion in the criteria of an offsetting model.

ISDA Master Netting Agreement

4. The following information is excerpted from Appendix A of the Board memo that was distributed for the June 2010 joint meeting to provide background information on the ISDA master netting agreement.

Description of ISDA Master Agreement Framework

5. The contractual agreements documenting and governing derivative transactions have been standardised to a great extent by the financial industry and ISDA. The financial industry utilise in almost all cases, the terminology, definitions and forms of agreements developed by ISDA.
6. The ISDA master agreement involves a pre-printed master agreement (either local jurisdiction single currency or multicurrency-cross-border), a schedule, and a form of confirmation. Generically, these documents are often referred to together as an ISDA.

Master agreement

7. The Master Agreement specifies the general terms of the agreement between counterparties with respect to general questions such as netting, collateral, definition of default and other termination events, calculation of damages (on default) and documentation. The master agreement contains the terms and conditions by which all (or as many as possible) relevant transactions between the parties are governed. Accordingly, one master agreement is entered into between a given market participant and each of its counterparties regardless of how many individual transactions are in place between it and each counterparty.
8. Multiple individual transactions are subsumed under this general Master Agreement forming a single legal contract of indefinite term under which the counterparties conduct their mutual business. Individual transactions are handled by confirmations that are incorporated by reference into the Master Agreement. Placing individual

transactions under a single master agreement that provides for netting of covered transactions has the effect of avoiding any problems netting agreements may encounter under various bankruptcy regimes. Having only a single contract between each pair of counterparties to a Master Agreement also eliminates the problem of netting multiple contracts.

Confirmation

9. Confirmations provide the specifics of each trade between the two parties. The Confirmation also "confirms" the payment terms. It does not, however, contain the many important contractual terms and other elements found in a typical finance contract. Instead, these terms and provisions are documented in the Master Agreement. Each Confirmation is incorporated directly into the Master Agreement itself, as opposed to being treated as an individual and distinct contract. The ISDA Master Agreement specifies that the confirmation supplement, forms part of, and is subject to, the ISDA Master Agreement.

Schedule

10. The schedule is used to make certain elections and any modifications (additions and deletions) to the standard terms in the pre-printed form (Master Agreement).

Other documents

11. If appropriate, credit support documents (guarantees and pledge agreements) are also annexed to the master agreement. There are also definitional booklets which are incorporated by reference into the other documents.

Master Netting Agreements – Netting provisions

12. The following offset provisions are available under the ISDA Master Agreement and similar agreements:

    a. **Single agreement provision**: This is a contractual provision whereby the parties agree that all contracts between them shall be consolidated into a single contract as soon as each new contract is entered into. Section 1(c)

of the ISDA Master Agreement, entitled Single Agreement, specifies that the master and all transactions under it form a single agreement. Under the ISDA Framework, multiple confirmations ('transactions') are subsumed under the Master Agreement forming a 'single' legal contract of indefinite term under which the counterparties conduct their mutual business. An advantage of the 'single' agreement provision could be that it reduces the counterparty's risks, and the existence of the net obligation represents an advantage also for the needs of capital adequacy reporting.

b. **Payment Netting:** Under payment netting provisions, both contracting parties undertake to accept the net performance of the other party. It may apply only to amounts or deliveries due on the same date and only if the payments are in the same currency or are the same asset. Section 2 of the ISDA Master Agreement, entitled "Obligations", addresses payment offset. This provision ensures **automatic offset** of each party's obligation to make payments (automatic satisfaction and discharge) and replacement with an obligation to make payment or a right to receive payment of the net sum. This provision may be applied to cash flows resulting from multiple transactions where payments occur on the same date and in the same currency, if parties so elect in the schedule or in the confirmation. The advantages of this type of netting include a reduction in transaction costs connected with the payment of the offsetting claims, lowering of risk of insufficient liquidity and occurrence of errors.

c. **Close-out netting**: Close-out netting is a contractual mechanism, enabling unilateral termination of a financial contract (or financial contracts governed by a master agreement), in the case of a bankruptcy or other event stipulated in the agreement, and at the same time the "netting" of their replacement values into a final balance, usually referred to as the "termination amount". The cost of the replacement of individual positions in such transactions by new ones is determined, taking account of market prices. The market price set in this manner is then converted into one currency and the net position established. A net payment is then made at this time. The party that is out-of the-money is obligated under the master agreement to pay the net amount to the in-the money party, regardless of who is the defaulting party.[1] Sections 5, 6 and 9 of the ISDA Master Agreement set out a detailed mechanism for close-out netting under the ISDA Framework. This process is intended to reduce exposures on open

[1] This assumes that the non-defaulting party elects to exercise their right to close-out net.

contracts if one party should become insolvent or a like event occurs before the settlement date.

Views of a group of leading international financial lawyers (February 2010 Education Session)

13. The question of the availability of netting arises primarily on insolvency which is when it really matters. Most countries allow netting prior to insolvency of a party, but this is irrelevant because, if parties can pay, the remedies are not needed.

14. One of the points in their presentation was the importance of cross-border considerations because different countries have different legal environment and local laws in some countries may not recognize the typical English law or New York law). Some countries are known to be debtor-friendly while others are creditor-friendly with respect to permitting set off on insolvency.

15. The group's presentation included world maps showing the type of legal environment in different countries as of 2007 when a legal firm had performed a survey on the netting issue.

16. They noted that the international position on set off and close out netting is extremely disharmonious. As a result some jurisdictions have developed protective statutes ('care-outs') which allow for set off and netting only in financial markets. The carve-outs, however, protects only certain types of financial contracts or only contracts between certain counterparties or only if the contract is a specified market contract.

17. The group also raised the following concerns about the master netting agreement:

    a. Generally speaking, close out netting is available at the option of the non-defaulting party. That party may decide not to trigger the cancellation procedures if the outcome, in financial terms, would be detrimental to it

    b. At the same time, however, the non-defaulting party may be entitled to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty

c. Typically, in the case of these trading contracts, other amounts may also be payable which are eligible for the overall set off e.g margin deposits and unpaid amounts owing by one party in respect of deliveries which have already been made by the other party. The validity of collateral worldwide is complex. The position can be intriguing where a non-defaulting party is out of the money and so decides not to terminate on the insolvency of the other party. This is even more problematic as some of the collateral provisions in the agreement may be challenged at law in insolvency.

d. Master Agreements are predicated primarily on concepts of New York Law and English Law, with the result that those common law systems are capable of generating some subtle but significant alterations in the understanding of those concepts over time through court judgments. Similarly, consensus market views of the law in particular contexts may not necessarily be sanctioned by courts in the long run.

Summary of the ISDA Paper on Enforceability

18. In July 2010, the staff received from ISDA their paper that was prepared in response to the board's request for additional information on this issue[2]. Paragraphs 19 through 32 below provide a summary of the key points from ISDA's July 2010 paper.

[2] http://www.isda.org/c_and_a/pdf/The-effectiveness-of-netting.pdf

Meaning of "Enforceability"

19. "Enforceability" in this context comprises two elements: first, enforceability as a matter of contract law under the governing law of the contract (typically English law or New York law); second, consistency with the bankruptcy laws of the jurisdiction where the counterparty is located. The latter is critical since, regardless of the law selected to govern the contract, local insolvency law in an insolvent party's jurisdiction will always override in the event of insolvency.
20. ISDA is not aware of any instances in which the close-out netting provisions of the ISDA Master Agreement were found to be unenforceable in instances in which ISDA has published an opinion confirming such enforceability.
21. Note that 'enforceability' relates to the fact of net payments, not to their amount. Parties may from time to time have commercial disagreements concerning the valuation of derivatives, as they do for other financial instruments, but these are unrelated to the enforceability of netting.

Legal Basis for Close-out netting

22. Close-out netting under the ISDA Master Agreement consists of three principal elements: early termination; valuation of the terminated transactions; and an accounting of those values, together with amounts previously due but unpaid, to arrive at a single net sum owing by one party to the other.
23. As a contractual matter, outside of bankruptcy, all three of these elements are effective as a matter of both English and New York law (and also under some other laws, though is only officially supported for English and New York law). In order for close-out netting as a whole to be enforceable against a party incorporated in a particular jurisdiction, however, each of them must also stand up in the bankruptcy of that counterparty. The legal analysis in support of this in each jurisdiction differs depending on the laws of that jurisdiction, though certain common elements can be identified.
24. In many jurisdictions, specific legislation exists that provides for the enforceability in bankruptcy of close-out netting under an ISDA Master Agreement or similar netting

agreement, often by way of specific exception from more general prohibitions on the exercise of creditors' rights. This is the case, for example, in the United States. In others, such enforceability is based on established general principles of law or on legislative exemptions. This is the case, for example, in England and those jurisdictions that derive their legal system from England's (though England now also has specific legislation providing for a special resolution regime for banks and building societies under the Banking Act 2009; close-out netting is explicitly protected).

25. The recent, and ongoing, litigation arising from the bankruptcy of various Lehman Brothers entities has not impacted the enforceability of the close-out netting provisions of the ISDA Master Agreement. The widely-reported *Metavante* decision in the United States Bankruptcy Court confirmed that, as a matter of US bankruptcy law, a party's right to rely on Section 2(a)(iii) of the ISDA Master Agreement in order to withhold its payment from a defaulting party whilst not closing out does not exist indefinitely. This decision was neither surprising nor material to the enforceability of close-out netting.

ISDA's Netting Opinions

26. In order to obtain regulatory capital relief against offsetting derivatives positions with a counterparty, ISDA's members that are subject to prudential capital requirements are required to obtain reasoned, written legal opinions that confirm the enforceability of the close-out netting provisions of master netting agreements that they use (the ISDA Master Agreement being by far the most widely used). They must obtain such opinions in respect of all relevant jurisdictions: their home jurisdiction, the jurisdiction of incorporation of their counterparty, each jurisdiction in which the counterparty has a branch though which it trades under the agreement, and the jurisdiction of the governing law of the agreement.
27. In response to this requirement, ISDA commissions and publishes legal opinions in a standard format as to the enforceability of the close-out netting provisions of the ISDA Master Agreement in relation to a wide range of entity types in various jurisdictions. Currently ISDA publishes 55 such opinions, which are updated on an

annual cycle. A list of the opinions is available at ISDA's website. (At the February 2010 joint educational Board meeting, a representative from ISDA noted that this list includes most major economies except for China and Russia.)

28. ISDA's legal opinions cover both pre- and post-insolvency aspects of enforceability, to a "would" level of certainty. In relation to contractual enforceability, they assume that either English law or New York law is selected as the governing law and that the relevant provisions of the ISDA Master Agreement are enforceable as a matter of contract law (i.e. absent bankruptcy), under those laws. The English law and New York law opinions confirm that assumption.
29. In relation to enforceability in bankruptcy, local counsel in each covered jurisdiction provides a review of applicable bankruptcy laws in their jurisdiction and responds to a detailed set of standard questions that address all relevant aspects of bankruptcy laws relevant to the entities covered. It is noteworthy that whilst a normal legal opinion will exclude the effect of bankruptcy, the ISDA opinions specifically include it, since that is their purpose.

ISDA's Law reform Activities

30. Prior to commissioning an opinion in a particular jurisdiction, ISDA works with counsel and members in that jurisdiction to understand the legal issues and, if necessary, to promote changes in the law to provide for the enforceability of close-out netting.
31. As part of this activity, ISDA publishes a Model Netting Act (MNA), together with an explanatory memorandum. The MNA has been used as the basis for netting legislation in several jurisdictions, including Mauritius, BVI, Pakistan (draft pending) and Seychelles (draft pending). Parts of the MNA can be found in current proposals under discussion in Malaysia. Also, the MNA has to different degrees inspired recent legislation in Slovenia, Hungary (in 2001), UK (Safeguards Order) and Ireland (NAMA bill). The MNA is also the basis for the proposal to Unidroit for a global netting convention and the EFMLG/ISDA proposal for an EU netting directive.
32. All of this ISDA work is done in order to ensure there is a legal environment in which enforceability is ensured.

Some Staff's Views

33. Paragraphs 34 through 82 presents the views of some of the staff. Following the presentation of these views, an alternative view is presented (of some of the staff).

Staff research on enforceability of master netting agreements – some problems

34. At the February 2010 education session a group of leading experts in international financial law[3] raised certain concerns about the effectiveness of termination and close-out netting provisions in bilateral contracts, in particular the ISDA master agreement. Following the Boards' request, the IASB staff has reengaged with some of these lawyers and other leading practitioners in international financial law on the subject. The staff has also conducted extensive research on enforceability of master netting agreements. Some of these issues are highlighted in this section. The following (selected) issues are addressed in this section:

    (a) Uncertainty about counterparty rights in insolvency/bankruptcy

    (b) Limited precedents and lack of definitive guidance

    (c) ISDA Legal opinions

    (d) Possible issues with the ISDA master netting agreement - Non-defaulting party's right not to make payment of amounts due

    (e) Possible issues with the ISDA master netting agreement - Non-defaulting party's right not to issue notice of early termination

    (f) Problems with the ISDA master netting agreement - Collateral issues

    (g) The effect of the mutuality doctrine (Group arrangements)

[3] This group of leading experts in international financial law consisted of lawyers invited by the staff and did not include any of the legal experts noted in the alternative views below. However, this group did include a lawyer from Allen & Overy, in which the lawyer participated in their personal capacity only. It should be noted that this lawyer spoke strongly in favor of the enforceability of close-out netting at the February 2010 education session.

Conclusions of these staff

35. Some staff believe that there is authority that the ISDA Master Agreement will function properly provided both parties to the Master Agreement are solvent and willing to comply with it. Where matters become complex, however, is in the situation in which one party goes into insolvency or in which one party refuses to be bound by its obligation to pay or in which the contract is held to be ultra vires by one of the contracting parties.

36. Those staff believe, based on decided cases and binding precedents, that some provisions of or added to the ISDA master agreement may not be upheld in some jurisdictions and that courts in different jurisdictions may arrive at different conclusions in the same case or fact pattern.

37. They also believe that there is limited decided case law in any jurisdiction relating specifically to financial derivatives -thus making it difficult to project the outcome of some of these contracts or some of the provisions in such contracts in a bankruptcy scenario. They argue that many of the complexity of the underlying financial structures involving derivatives are yet to be analysed for the first time from a real world bankruptcy perspective.

38. Currently ISDA publishes legal opinions on this issue covering 55 countries (including most major economies except for China and Russia). These staff note that there are more than 55 countries in the world and the opinions do not cover all the countries that apply IFRSs or are about to adopt IFRSs, for example. These staff therefore question the appropriateness of basing the development of global accounting guidance on such opinions.

39. They also argue that the legal opinion is intended to provide a measure of assurance that the master agreement provisions are valid and that it gives rise to enforceable obligations and rights against the parties but there are a number of limitations, however, that concern the scope and contents of such opinions and the consequences in receiving them. They also believe it is problematic to base accounting guidance on

legal opinions, as evidenced by the recent financial crises. An entity may engage in opinion shopping or conduct transactions in jurisdictions where a favourable opinion may be obtained. Reliance on legal opinions also creates structuring opportunities and the decision to either net or not may be dependent on non substantive provisions in an agreement. The reliance on legal opinions may have unintended consequences and puts considerable pressure on auditors.

40. These staff believe that in some jurisdictions a non-defaulting party (in an ISDA master agreement) is entitled to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty as a result. Also, as close out netting is available at the option of the non-defaulting party (by contract), in some jurisdictions, the non-defaulting party may decide not to trigger the cancellation procedures if the outcome, in financial terms, would be detrimental to it.

Uncertainty about counterparty rights in insolvency/bankruptcy

41. If one party goes into insolvency, there are questions as to whether or not the insolvency code applicable to that party will permit the netting of all obligations owed under the master agreement.

42. One of the points raised by the group of lawyers at the February 2010 education session was the importance of cross-border considerations because different countries have different legal environment and local laws in some countries may not recognise the typical English law or New York law. Some countries are known to be debtor-friendly while others are creditor-friendly with respect to permitting set off on insolvency.

43. They noted, in their paper, that the international position on set off and close out netting is extremely disharmonious. As a result, some jurisdictions have developed protective statutes (‘carve-outs’) which allow for set off and netting only in financial markets. The carve-outs, however, protect only certain types of financial contracts or only contracts between particular counterparties or only if the contract is a specified market contract.

44. For example, in Perpetual Trustee Co. Ltd (Lehman Bros Holdings inc etal) v. BNY Corporate Trustee Services Ltd (see below for case summary), a court in the US ruled that the collateral security preferences (ie priority of payment in insolvency) specified in the ISDA Agreement cannot be upheld under US bankruptcy law.

45. However, the same case (same counterparties and fact pattern) was considered by the English courts (the governing law being English law) but they upheld the collateral provisions in the Master Agreement.

46. The US court also concluded that although the English courts have authoritatively interpreted the agreement in accordance with English Law and whilst respecting the determination as valid and binding between the parties, it is not obliged to recognise a judgment by a foreign court, but may choose to give effect to a foreign judgment on the basis of comity. It also noted that as a general matter, courts will not extend comity to foreign proceedings when doing so would be contrary to the policies or prejudicial to the interests of the United States.

47. This points to the fact that some provisions of or added to the ISDA master agreement may not be upheld in some jurisdictions and that courts in different jurisdictions may arrive at different conclusions in the same case or fact pattern.

Limited precedents and lack of definitive guidance

48. It is comparatively rare for cases involving complex financial products to go to court precisely because financial institutions are reluctant to enter into the expense and to risk the publicity associated with litigation. The market tends to shy away from litigation which will result in the payment of damages when the parties can usually commit to a financial compromise between them. Where a financial institution is dealing with a valued client it will generally not wish to sour that relationship by pushing matters to a court. Where the issue arises between two financial institutions, the parties will generally prefer to go to arbitration where the claims and remedies can be defined between themselves.

49. Thus there is few decided case law in any jurisdiction relating specifically to financial derivatives and for most part the derivatives markets are only lightly dusted with

decided caselaw. Some staff believe that this makes it difficult to project the outcome of some of these contracts or some of the provisions in such contracts in a bankruptcy scenario.

50. This point was made clear by the Judge in Perpetual Trustee Co. Ltd (Lehman Bros Holdings inc etal) v. BNY Corporate Trustee Services Ltd. The judge commented that – "*One of the distinguishing characteristics of the Lehman bankruptcy cases is the complexity of the underlying financial structures many of which are being analyzed for the first time from a real world bankruptcy perspective. It is expected, as a result, that the cases of LBHI and LBSF on occasion would break new ground as to unsettled subject matter. This is one such occasion*"[4].

51. These staff believes this will particularly be more pertinent in situations where there is no (or only limited) available legislation or authority or other reliable guidance on the point in issue and in jurisdiction with less vibrant commercial law advocacy.

ISDA Legal opinions

52. In the light of the problems highlighted above, ISDA has obtained and publishes legal opinions on the enforceability of the close-out netting provisions of the ISDA Master Agreement in some countries. Currently ISDA publishes legal opinions on this issue covering 55 countries (including most major economies except for China and Russia).

53. These staff notes that there are more than 55 countries in the world and the opinions do not cover all the countries that apply IFRSs or are about to adopt IFRSs, for example. The staff therefore questions the appropriateness of basing the development of global accounting guidance on such opinions.

54. A legal opinion on enforceability of a Master Agreement may be written by a lawyer or a law firm and it addresses various legal issues that relate to the master agreement. The legal opinion is intended to provide a measure of assurance that the master agreement provisions are valid and that it gives rise to enforceable obligations and

[4] The some staff note that the comments of the judge does not relate to transactions pursuant to a ISDA master netting arrangement, see discussion of the matter being discussed below in the Staff's Alternative View.

rights as against the parties, and if assets are transferred as security, the creation of the security.

55. There are a number of limitations, however, that concern the scope and contents of such opinions and the consequences in receiving them:

    (a) In the first place, they are (as their title indicates) opinions concerning the law and not cast iron guarantees of the legal position. It follows that an opinion may have been expressed in good faith and on reasonable grounds but it may turn out to be incorrect. This may particularly be the case in situations where there is no (or only limited) available legislation or authority or other reliable guidance on the point in issue or where a change may have occurred since a search or other investigation was carried out on which the opinion is based. It follows that the mere fact that an opinion sets out a conclusion as to the legal position on an issue does not mean that the law must inevitably be as it was stated.

    (b) Secondly, the opinion is given subject to a number of qualifications relating to matters of law which may adversely affect or qualify the legal rights and obligations that might be expected to arise under the agreement or transaction.

56. While the ISDA Master Agreement is a preprinted form, it is designed to be negotiated and custom-tailored to the needs, circumstances, and expectations of the two counterparties. The parties to an ISDA Master Agreement are expected to append further terms and provisions to a Schedule to the Master Agreement, which can have the effect of altering the agreement radically from the standard language. The parties may add or alter these agreements in ways which were not intended by the drafters of the standard form of the agreement and hence the writers of the legal opinion.

Possible issues with the ISDA master netting agreement - Non defaulting party's right not to make payment of amounts due

57. In many jurisdictions the provisions of the ISDA Master, as supplemented in the Schedule, are enforceable in accordance with their terms. Some of these jurisdictions

uphold freedom of contract, a cardinal feature of the ISDA architecture, and hold the parties to their negotiated bargain.

58. As with any freely negotiated contract, some of the provisions may have undesirable consequences. Although certain provisions have undesirable or unexpected consequences for one party that can be exploited by the other, this will not however persuade the courts or give the courts power, in some of those jurisdictions, to rewrite the contract.

59. As noted by the group of lawyers at the February 2010 education session, the non-defaulting party may be entitled to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty as a result. The ISDA Master Agreement imposes a conditions precedent on the payment obligations of each of the parties, in particular, that no actual or potential event of default, has occurred and is continuing with respect to the other party, and that nothing has occurred which has led to action being taken to achieve an early termination of the outstanding transactions under the agreement.

60. In effect, the payment obligations of the non-defaulting party are suspended where the condition concerns an event of default relating to the other party and the payment obligations of both parties are suspended if the termination procedures have been commenced.

61. An example of the operation of such a provision can be seen in the Australian case of *Enron Australia Finance Pty Ltd v TXU Electricity Ltd*. In that case, an insolvency event of default had occurred with respect to Enron. In reliance upon the condition precedent in the Master Agreement that no default should have occurred relating to that party, TXU (the non-defaulting party) refused to make payments that would have otherwise fallen due to be made by it. The court held that the other party was entitled to rely on the provision, even though on a net basis it owed money to Enron (the insolvent party) and despite the fact that it had not exercised its rights to terminate the transaction following the occurrence of the insolvency of Enron.

62. The conclusion of the lower court in this case was upheld by the Supreme Court. This is now, by virtue of the legal system in Australia, the law governing such contracts. The staff notes that TXU did not make any payments as it would have had to under the close out netting provision.

63. A similar conclusion was reached by the court in England in the case of *Marine Trade S.A. -v- Pioneer Freight Futures Co Ltd and another [2009].* That case provides an English authority for the proposition that a party may rely on Section 2(a)(iii) of the ISDA Master Agreement to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty and provides some insight as to the conclusions that an English judge might reach if ISDA Master Agreements concerning Lehman Brothers entities were to be litigated in England. This is in contrast to the position in the US following recent litigation there (see appendix B - the *Metavante* decision).

64. In HM Treasury's consultation document, "*establishing resolution arrangements for investment banks*[5]", the UK government noted that – "the ISDA Master Agreement provides that the obligations of a party under each transaction under the Master Agreement are conditioned upon the other party not defaulting. This condition precedent is set out in section 2(a)(iii) of the Master Agreement. The Master Agreement allows the non-defaulting party to treat the insolvency event as an event of default and gives it the right, but not the obligation, to terminate all transactions under the agreement. Contractual sections such as section 2(a)(iii) are valid under UK law, if properly drafted so as not to offend the "anti-deprivation principle". Section 2(a)(iii) can be relied upon by the non-defaulting counterparty effectively to "suspend" payments to the defaulting counterparty. Although technically there is no suspension of payments due to section 2(a)(iii) the payment obligations do not arise because the condition precedent is not fulfilled."

65. Due to the problems these precedents pose, the Joint Administrators of Lehman Bros International Europe ('LBIE') made an application in May 2010 to the High Court for

[5] See paragraph 7.7

directions as to the meaning and effect of Section 2 (a) (iii) of the ISDA Master Agreement. The Joint Administrators are concerned that certain counterparties to derivatives transactions with LBIE may opt not to close out the transactions under their ISDA Master Agreement for a long period, or indefinitely, by relying on Section 2 (a) (iii), thereby avoiding making payments that would otherwise have been due to LBIE. The Application asks (amongst other things) whether reliance on Section 2 (a) (iii) to withhold payments to a party that is in administration is permitted as a matter of English Law[6].

66. Some staff believe that these precedents cast doubt on the efficacy of the Master Netting Agreement and raises concerns about the potential for courts in different jurisdictions to arrive at opposite conclusions on similar fact patterns or in interpretation of the same paragraph in the Master Agreement. Once again this points to a limitation of the master netting agreement itself and hence its usefulness as a credit mitigation tool. The staff notes that this raises possible concerns about the workings of the close out provision.

Possible issues with the ISDA master netting agreement - Non defaulting party's right not to issue notice of early termination

67. Also, as noted by the group of lawyers at the February 2010 education session on netting, generally, close out netting is available at the option of the non-defaulting party (by contract). That party may decide not to trigger the cancellation procedures if the outcome, in financial terms, would be detrimental to it (Note: this may not be possible in all jurisdictions around the world).

68. Section 6(a) of the ISDA Master Agreement deals with the right to terminate following an Event of Default. It enables the Non-defaulting Party to give a notice to the Defaulting Party designating an Early Termination Date in respect of all outstanding Transactions. Section 6(c) says that if an Early Termination Date has been effectively designated, no further payments or deliveries are required in respect

[6] At least four counterparties are seeking to rely on this provision and not make further payments to LBIE.

of the Terminated Transactions, and the amount (if any) payable is determined under Section 6(e).

69. A case in point is the Australian case of *Enron Australia Finance Pty Ltd v TXU Electricity Ltd*. In that case these clauses gave TXU, but not Enron, the contractual right to designate an Early Termination Date in respect of all outstanding Transactions, and then to settle by making or receiving a payment calculated under Section 6(e)(i)(3), thereby terminating those Transactions. While the Agreement in terms authorises TXU as the Non-defaulting Party to initiate the early termination procedure, it does not oblige TXU to do so. The position was that TXU would be obliged to pay a substantial amount to Enron, rather than the reverse, if it were to designate an Early Termination Date. It was obviously not in TXU's economic interest to take steps that would generate an obligation to make a large payment, when the obligation does not presently exist. In the absence of any such step being taken by TXU, there will continue to be no payment obligations in respect of any outstanding Transactions.

70. The court held that Enron (the defaulting party) is not entitled to disclaim the contract and effect an occurrence or designation of an early termination date. Moreover, the court concluded that it does not have power to make an order to require TXU to designate and early termination date under section 6(a) or to participate in any final settlement of obligations under section 6(e) as if such designation has occurred.

71. In the case of Lehman Brothers International Europe (LBIE), at least four parties are relying on section 2(a)(iii) to avoid obligations that otherwise would have accrued and will otherwise accrue to LBIE's favour under their respective outstanding derivative transactions. This is now been contested in court by the Joint Lehman Administrators.

72. In paragraph 7.8 of the HM Treasury's consultation document, "*establishing resolution arrangements for investment banks*", the UK government also noted that – 7.8 Section 2(a)(iii) does not specify a time period within which the non-defaulting counterparty needs to decide whether or not to terminate all transactions under the

ISDA Master Agreement, in effect allowing the non-defaulting counterparty to *suspend its decision indefinitely and during that time not to make any ongoing payments to the failed investment firm.* This is most likely to arise in practice where, on a termination, a net close-out payment would be owed by the nondefaulting counterparty to the failed firm.

73. The HM Treasury in paragraphs 7.9 – 7.14 of its consultation paper identified the possibility of a counterparty taking such a position as an issue of concern that, if a market solution is not found, legislation is likely to be required to prevent such a position being taken by a non-defaulting party in future insolvencies.

74. The above demonstrate that the close out netting provision might not be triggered in some jurisdictions.

The effect of the mutuality doctrine (Group arrangements)

75. The availability of set off is restricted to claims between contracting parties and not to claims in respect of third parties ('mutuality'). The doctrine of mutuality requires that one person's claim shall not be used to pay another person's debt. Each claimant must be the beneficial owner of the claim owed to him by the other or a clear partitioned share of it, and each claimant must also be liable for the claim owed by him to the other. Therefore legal personality of the parties to a Master Agreement cannot be ignored to give effect to set off. Parties will not be able to take those obligations into account in calculating a final net termination amount in the event of insolvency. For example, both a parent and subsidiary have outstanding contracts with a counterparty. In the insolvency of the parent or the subsidiary, the positions under either relationship with the counterparty may not be included in calculating any net amount payable or receivable.

Collateral

76. Close-out netting requires three steps on a counterparty default: cancellation of the unperformed contracts, calculation of the losses to each party resulting from the premature termination and then set-off of the losses either way on each contract, so as to produce a single net balance owing one way or another.

77. In the case of trading contracts, other amounts may also be payable which are eligible for the overall set off e.g margin deposits and unpaid amounts owing by one party in respect of deliveries which have already been made by the other party.

78. As noted by the group of lawyers at the February education session, the position can be complex as some of the collateral provisions in the agreement may be challenged at law in insolvency.

79. In Perpetual Trustee Co. Ltd (Lehman Bros Holdings inc etal) v. BNY Corporate Trustee Services Ltd (see below for case summary), a court in the US ruled that the collateral security preferences (ie priority of payment in insolvency) specified in the ISDA Agreement cannot be upheld under US bankruptcy law. However the same case (same counterparties and fact pattern) was considered by the English courts but they upheld the collateral provisions in the Master Agreement.

80. The facts involved in the Perpetual Appeal were briefly as follows (*the agreement was to be governed by English Law*).

81. As part of a number of transactions involving synthetic collateralised debt obligations (each taking basically the same form), a special purpose vehicle (the "SPV") issued notes to noteholders (the "Noteholders"). The SPV also entered into a derivatives transaction with LBSF by way of a credit default swap. The obligations of the SPV to the Noteholders (for principal and interest on the notes) and to LBSF (for amounts due to LBSF under the swap, for instance, on termination) were secured under a security trust deed and associated documents in favour of a trustee. The documentation allocated priority of recoveries as between the Noteholders and LBSF if the security became enforceable, in the first instance in favour of LBSF. That priority, however, was reversed under the documentation if LBSF were the defaulting party under the derivates transaction, including in consequence of an insolvency event concerning it or its parent company. A filing for US Chapter 11 bankruptcy proceedings of LBSF or its parent would constitute such an insolvency event. Such a filing concerning the parent occurred on 15th September, 2008 and a similar filing for LBSF occurred on 3rd October, 2008. Thereafter the security became enforceable.

LBSF contested the validity of its loss of priority, which had occurred in consequence of the first of the Chapter 11 filings relating to the parent, praying in aid the anti-deprivation rule.

82. This points to the fact that some provisions of or added to the ISDA master agreement may not be upheld in some jurisdictions and that courts in different jurisdictions may arrive at different conclusions in the same case or fact pattern.

An Alternative Staff View

83. Some staff believe that the views raised in the section above are interesting points about ISDA master netting arrangements or may relate to cases involving ISDA master netting arrangements but these staff believe that none of the staff have found instances where (i) the right of a non-defaulting party to elect to close out net has been successfully challenged in the jurisdictions where ISDA has obtained a legal opinion for, (ii) the defaulting party has had to pay more than its net obligation to the non-defaulting party even though there have been cases, as noted above, where the non-defaulting party has elected to suspend its performance, and (iii) the collateral posted or received pursuant to a standard ISDA master netting arrangement has not been honoured in accordance with the agreements terms. Further, these staff disagree with the conclusions expressed by the other staff in paragraphs 37 through 40 for the reasons cited below.

84. The observations of these staff are principally based upon discussions and written communications with two highly respected international law firms that are experts in ISDA master netting arrangement matters, David Polk & Wardwell and Allen & Overy, the legal departments of two major financial institutions, and the legal group of ISDA. Theses staff have quoted the views of the law firms; however, it should be noted that one of the law firms was engaged by one of assisting financial institutions while the other was engaged by ISDA to respond to the staff's inquiries about these matters because of their specific legal expertise. In general, the these staff believes that the legal enforceability of the right of offset should be determined by the entity's

management and its auditors based on the opinions of legal counsel (both internal and external) and on the facts and circumstances specific to their individual cases.

Uncertainty about counterparty rights in insolvency/bankruptcy

85. These staff's views on this subject are addressed under other subheadings below, therefore, are not repeated here.

Limited precedents and lack of definitive guidance

86. Regarding the other staff's views on this subject described above in paragraphs 48 through 51, the staff with an alternative view obtained the following:

    (a) David Polk & Wardwell commented:

    *It is true that the enforceability of close-out netting in an insolvency of the counterparty will be determined by the laws of the counterparty's bankruptcy forum. However, **far from being disharmonious**, there is a broad trend toward the harmonization of the laws in various jurisdictions to expressly recognize the enforceability of close-out netting. This is true in Europe, the United States, Canada and Japan, and the trend is continuing in other jurisdictions as well, including Latin America. In addition, we understand that reporting entities look at netting enforceability on a jurisdiction-by-jurisdiction basis, and that a reporting entity should only give effect to close-out netting under US GAAP if it has obtained reasonable assurances, based on written legal advice, as to the enforceability of its contractual termination and netting rights in an insolvency of its counterparty under the laws of the counterparty's bankruptcy jurisdiction. **The fact that there may not be perfect uniformity throughout the globe should not affect the enforceability of netting rights in a given jurisdiction.** [emphasis added]*

    *We understand that netting decisions are approached by reporting entities on a jurisdiction-by jurisdiction basis and are based on written legal advice that provides reasonable assurances as to netting enforceability in that jurisdiction, whether such advice is based on specific netting legislation or on general legal principles. **If the law of a given jurisdiction is so unsettled that reasonable assurances of netting enforceability cannot be obtained, we understand that netting with counterparties in that jurisdiction is not appropriate under US GAAP and is not applied in practice. The fact that complex and novel legal issues may have emerged in the Lehman case (having nothing to do with the fundamental question of the enforceability of close-out netting) should have no bearing on a reporting entity's ability to rely on netting***

enforceability where it has reasonable assurances based on advice of counsel. *[emphasis added]*

(b) Allen & Overy commented:

There is authority that the ISDA Master Agreement will function properly provided both parties to the Master Agreement are solvent. Where matters require more analysis, however, is in the situation in which one party goes into insolvency. Where one party goes into insolvency, it is necessary to analyse whether or not the insolvency law applicable to that party will permit the netting of all obligations owed under the master agreement.

One of the points raised by the group of lawyers [at the February 2010 education session] is the importance of cross-border considerations because different countries have different legal environments. Regardless of the law selected by the parties, in an insolvency of one of the parties, the insolvency laws of the country of the insolvent party will apply to the extent that they are mandatory and conflict with the terms of the contract. Some countries are known to be debtor-friendly while others are creditor-friendly with respect to permitting set off on insolvency. However, countries in both groups have (where necessary) passed legislation to enable close-out netting under master netting agreements such as the ISDA Master Agreement. Thus the international position on set off and close out netting must be considered. ISDA has published opinions confirming the enforceability of close-out netting in 55 countries.

It is worth noting that the issue of the unwillingness of a party to perform is unrelated to the enforceability of close-out netting. If a party fails to perform under the ISDA Master Agreement, that will constitute an Event of Default and the other party can terminate all outstanding Transactions and trigger close-out netting. Issues of capacity and authority are common to all contracts.

In the Perpetual v. BNY case discussed above, the judge commented that – "One of the distinguishing characteristics of the Lehman bankruptcy cases is the complexity of the underlying financial structures many of which are being analyzed for the first time from a real world bankruptcy perspective. It is expected, as a result, that the cases of LBHI and LBSF on occasion would break new ground as to unsettled subject matter. This is one such occasion...#157;. This ***case related to*** *(and therefore the Judge's comments were directed at)* ***complex structured finance transactions that happened to include a derivative element and not to trading under an ISDA Master Agreement****. It may be that the complex*

> *structures at issue in those cases have not previously been tested from a "real world bankruptcy perspective",* ***but that is not true of the ISDA Master Agreement, which has been thoroughly tested and shown to work as expected (e.g. Enron, Barings).*** *Please also refer to the survey results which ISDA provided recently, showing ISDA's members' experience in closing out the ISDA Master Agreement which shows that there were no issues with the enforceability of the close-out mechanism of the ISDA Master Agreement in those jurisdictions in which ISDA has published a netting opinion. It is also worth noting that even in the Lehman bankruptcy, there are a handful of cases that are being litigated but thousands of ISDA Master Agreements have been closed out without incident. [emphasis added]*

87. Based upon the above input from the law firms, the staff with an alternative view believe that there are many precedents and definitive guidance in the jurisdictions where ISDA has obtained a legal opinion.

ISDA Legal opinions

88. With respect to the views in paragraph 53 noting that the ISDA legal opinions covering only 55 countries are not sufficient for a global application of IFRS, the staff with an alternative view understand that the vast majority of derivative contracts are executed in these 55 countries and believe that the legally enforceable right to offset upon a counterparties' default is an important economic right that should be considered for inclusion in the reporting entity's financial statements.
89. With respect to the views in paragraph 54 that legal opinions are not absolute guarantees, the staff with an alternative view acknowledge that point, however, believe that it is impossible to prepare financial statements without relying on legal opinions to some extent because there is never an absolute guarantee that any contract will not be interpreted in a novel way in the future. Financial statements generally are prepared on the facts and circumstances that exist as of the balance sheet date and the future is always difficult to predict and absolute guarantees are rare.
90. With respect to the views presented in paragraphs 55 and 56 above, the staff with an alternative view acknowledge that both preparers and auditors have to consider

whether the legal opinions that have been obtained relate to the facts and circumstances of the transaction that they are being assessedto determine whether offsetting is appropriate. However, these points do not appear relevant to standard setting.

Possible issues with the ISDA master netting agreement - Non defaulting party's right not to make payment of amounts due

Possible issues with the ISDA master netting agreement - Non defaulting party's right not to issue notice of early termination

91. With respect to the above two sections of the first set of staff views in paragraphs 58 through 74, the staff with an alternative view have obtained the following:

    (a) David Polk & Wardwell commented:

    Non-defaulting party's right not to make payment of amounts due

    > *The comments in this section [paragraphs 58 through 74] appear to* ***misconstrue the fundamental question, which is whether the reporting entity, as the non-defaulting party, has enforceable rights to terminate and net transactions in an insolvency of its counterparty. The Australian Enron-TXU case goes to a completely different issue, which is whether the non-defaulting party can be forced by the debtor to exercise its termination rights****, or whether it can instead rely on the alternative rights in Section 2(a)(iii) of the ISDA Master Agreement to keep the contract open and withhold performance. In the Enron-TXU case, the Australian court found that TXU (the non-defaulting party) was entitled to keep the contract open. The fact that the non-defaulting party may not be forced to terminate does not, however, interfere with the enforceability of its right, in an insolvency of its counterparty, to terminate and net transactions.* ***Accordingly, it does not undermine reasonable assurances of netting enforceability from the perspective of the non-defaulting party seeking to net in the debtor's insolvency****.*
    >
    > *The fact that the Lehman court in Metavante in the U.S. did not agree with the Enron-TXU decision and held that a non-defaulting party could not withhold performance under Section 2(a)(iii) of the ISDA Master Agreement indefinitely also* ***does not undermine the right of the non-defaulting party to terminate and net swaps and other qualified financial***

transactions in a timely fashion upon the counterparty's bankruptcy filing*, which the Metavante court noted is protected by the Bankruptcy Code safe harbors. Whichever way a court comes out on the enforceablity of Section 2(a)(iii) does not affect the right of the non-defaulting party to close out and net so long as it has reasonable assurances as to the enforceability of such close-out netting rights based on written legal advice. [emphasis added]*

Non-defaulting party's right not to issue notice of early termination

As noted above, the fact that the non-defaulting party is not obligated under the ISDA Master Agreement to give notice of termination and net does not undermine its right to do so. We understand that netting determinations for US GAAP purposes have always been based on whether the reporting party has reasonable assurances that its termination and netting rights are enforceable, not that the reporting party must be forced to exercise those rights. ***The key question is whether the reporting party is justified in looking at the relevant exposures on a net basis because the ability to terminate and net is within its control and cannot be disrupted by the insolvency of its counterparty, and thus it cannot be forced to pay on a gross basis.*** *[emphasis added]*

(b) Allen & Overy rewrote the discussion of these topics as follows:

Non-defaulting party's right not to make payment of amounts due

As noted by the group of lawyers at the February 2010 meeting, under Section 2(a)(iii) of the ISDA Master Agreement, a non-defaulting party may be entitled to effectively "suspend" the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty as a result. The ISDA Master Agreement imposes conditions precedent on the payment obligations of each of the parties, in particular, that no actual or potential event of default has occurred and is continuing with respect to the other party, and that nothing has occurred which has led to action being taken to trigger an early termination of the outstanding transactions under the agreement. Strictly speaking, the obligations are not "suspended"; rather, they do not arise until the condition precedent is satisfied.

An example of the operation of such a provision will be seen in the Australian case of Enron Australia Finance Pty Ltd v TXU Electricity Ltd. In that case, an insolvency event of default had occurred with respect to one party. In reliance upon the condition precedent in the Master Agreement that no default should have occurred relating to that party, the

other (non-defaulting) party "suspended" the payments that would have otherwise fallen due to be made by it. The court held that the other party was entitled to rely on the provision, even though on a net basis it would (but for the application of Section 2(a)(iii)) have owed money to the insolvent party.

The same conclusions were reached by the court in England in the case of Marine Trade S.A. -v- Pioneer Freight Futures Co Ltd and another [2009]. That case provides an English authority for the proposition that a party may rely on Section 2(a)(iii) of the ISDA Master Agreement to suspend the performance of its own obligations whilst the relevant default event applies to the defaulting counterparty and provides some insight as to the conclusions that an English judge might reach if ISDA Master Agreements concerning Lehman Brothers entities were to be litigated in England, though it should be noted that neither party to this case was subject to insolvency proceedings.

The result in the Marine Trade case is in contrast to the position in the US following recent litigation there (i.e., the Metavante decision). Although the lack of clear reasoning in the Metavante decision is unhelpful, the decision was not a surprise. Law firms had generally advised clients not to assume that they could rely on Section 2(a)(iii) indefinitely. Unfortunately, it is impossible to determine from the Metavante ruling the period for which a party can rely on Section 2(a)(iii), other than that it is, presumably, less than a year.

The Joint Administrators of Lehman Bros International Europe ('LBIE') made an application in May 2010 to the High Court for directions as to the meaning and effect of Section 2(a)(iii) of the ISDA Master Agreement. The Joint Administrators are concerned that certain counterparties to derivatives transactions with LBIE may opt not to close out the transactions under their ISDA Master Agreement for a long period, or indefinitely, by relying on Section 2(a)(iii), thereby avoiding making payments that would otherwise have been due to LBIE. The Application asks (amongst other things) whether reliance on Section 2(a)(iii) to withhold payments to a party that is in administration is permitted as a matter of English Law.

***The purpose of Section 2(a)(iii) is to protect a party from incurring additional exposure to a party who is on the cusp of default or has already defaulted**. **It plays no role, however, in the operation of close-out netting.** Where a Potential Event of Default has occurred with respect to a party, the other party has no right to designate an Early Termination Date under the ISDA Master Agreement. If it were not for Section 2(a)(iii), the other party, if it were due to make a payment or deliver assets to the potentially defaulting party, would potentially be forced to choose between*

defaulting itself or increasing its exposure to the potentially defaulting party by making the payment or delivery. Section 2(a)(iii) solves this dilemma for the other party. In the case of a Defaulting Party, the Non-defaulting Party has the right to designate an Early Termination Date, but it is not always in its best interests to do so. First, the Event of Default may be relatively easily cured, for example, a payment default due to a technical or administrative, rather than credit-related, reason. Secondly, depending on the nature and seriousness of the default, it may be that a solution that avoids the necessity to close out can be negotiated. Requiring the Non-defaulting Party to close out immediately removes this possibility. Closing out imposes costs on both parties, is disruptive to the parties and possibly other market participants with related positions and possibly the market more generally.

It has been pointed out that, in certain circumstances, Section 2(a)(iii) may permit a non-defaulting party that is out of the money to effectively "suspend" its payments indefinitely without ever closing out. However, there is no guarantee that a non-defaulting party would be able to do this, since, firstly, that party may itself become subject to an Event of Default, which would permit the other party to terminate and, secondly, the original Event of Default may be cured, thus satisfying the condition precedent. We note also that, even where the non-defaulting party has the right not to terminate, many out-of the-money non-defaulting parties do in fact terminate; we understand, for example, that in the case of Lehman Brothers International Europe, all bank counterparties, even those that were out of the money, terminated, and only a handful of corporate counterparties have not done so (hence the case referred to above). *Nevertheless, some regulators have focused on this potential effect of Section 2(a)(iii) in the default of a major market participant. For example, the UK Treasury's December 2009 consultation document Establishing resolution arrangements for investment banks has specifically raised this issue and encouraged a market solution to it. ISDA has accordingly started a process of consultation with its membership, a process which may result in an amendment to Section 2(a)(iii) to limit this ability of the non-defaulting party to elect not to terminate for a potentially extended period of time.*

In any event, the application of Section 2(a)(iii), and the potential that it has to permit the non-defaulting party to effectively hold out indefinitely without terminating or settling, is not relevant to the enforceability of close-out netting. *Even if a Court were to find that Section 2(a)(iii) of the ISDA Master Agreement was not enforceable, this would not affect the enforceability of close-out netting.* ***ISDA's 55 netting opinions do not rely on Section 2(a)(iii) to reach their positive conclusions.*** *[emphasis added]*

Non-defaulting party's right not to issue notice of early termination

Also, as noted by the group of lawyers at the February 2010 education session on netting, generally, ***close out netting is available at the option of the non-defaulting party****. That party may decide not to trigger the cancellation procedures if the outcome, in financial terms, would be detrimental to it (Note: this may not be possible in all jurisdictions around the world). A case in point is the Australian case of Enron Australia Finance Pty Ltd v TXU Electricity Ltd.*

Section 6(a) deals with the right to terminate following an Event of Default. It enables the Non-defaulting Party to give a notice to the Defaulting Party designating an Early Termination Date in respect of all outstanding Transactions. Section 6(c) says that if an Early Termination Date has been effectively designated, no further payments or deliveries are required in respect of the Terminated Transactions, and the amount (if any) payable is determined under Section 6(e).

In that case these clauses gave TXU, but not Enron, the contractual right to designate an Early Termination Date in respect of all outstanding Transactions, and then to settle by making or receiving a payment calculated under Section 6(e)(i)(3), thereby terminating those Transactions. While the Agreement in terms authorises TXU as the Non-defaulting Party to initiate the early termination procedure, it does not oblige TXU to do so. The position was that TXU would be obliged to pay a substantial amount to Enron, rather than the reverse, if it were to designate an Early Termination Date. It was obviously not in TXU's economic interest to take steps that would generate an obligation to make a large payment, when the obligation does not presently exist. In the absence of any such step being taken by TXU, there will continue to be no payment obligations in respect of any outstanding Transactions.

The court held that Enron (the defaulting party) is not entitled to disclaim the contract and effect an occurrence or designation of an early termination date. Moreover, the court concluded that it does not have power to make an order to require TXU to designate and early termination date under Section 6(a) or to participate in any final settlement of obligations under Section 6(e) as if such designation has occurred. [emphasis added]

92. Based upon the above views, the staff with alternative view disagree with the other r staff's view expressed above.

The effect of the mutuality doctrine (Group arrangements)

93. Regarding the questions raised by the first view described above in paragraph 75 concerning mutuality, the staff with an alternative view obtained the following:

    (a) Allen & Overy commented:

    The availability of set off is restricted to claims between contracting parties and not to claims in respect of third parties ('mutuality') The doctrine of mutuality requires that one person's claim shall not be used to pay another person's debt. Each claimant must be the beneficial owner of the claim owed to him by the other or a clear partitioned share of it and each claimant must also be liable for the claim owed by him to the other. Therefore legal personality of the parties to a Master Agreement cannot be ignored to give effect to set off. ***However, although parties to ISDA Master Agreements may trade through various legal entities, they do not seek to apply set-off or netting across those entities****. Rather, they risk manage and account on a legal entity basis and will enter into a separate ISDA Master Agreement for each pair of entities that enters into derivatives contracts. The fact that they may trigger cross default or other events of default by reference to other group entities does not alter this position since that goes only to the right to terminate, and not to the calculation of amounts due upon termination. [emphasis added]*

    (b) David Polk & Wardwell commented:

    The fact that there may be issues in many jurisdictions with respect to cross-affiliate netting is entirely irrelevant for purposes of balance sheet netting*, which we understand is limited to bilateral netting. For example, if a single reporting entity has two ISDA Master Agreements with two debtor affiliate counterparties, where one Master Agreement is in the money and the other Master Agreement is out of the money to the reporting entity, we understand that the reporting entity would not seek to net those two Master Agreements for balance sheet purposes under US GAAP.* ***The fact that there may be cross-default provisions in the Master Agreements allowing the reporting entity to terminate transactions has no bearing on whether the resulting termination payment amounts would be netted. We understand that under US GAAP the reporting entity should not seek to net its receivable and payable with the two affiliated counterparties for balance sheet purposes.*** [emphasis added]

94. Based on the above comments and the staff with the alternative view's understanding that reporting entities do not offset receivables and payables based on cross-affiliate provisions of the ISDA master netting arrangement due to uncertainties about legal enforceability, these staff believe that the concerns raised by the other staff are not indicative of an unknown issue or question with ISDA master netting arrangements.

Collateral

95. Regarding the questions raised by some staff concerning collateral in paragraphs 76 through 82, the staff with an alternative view obtained the following:

    (a) David Polk & Wardwell commented:

    The Perpetual Trustee v. BNY case (otherwise known as the Dante case) has no bearing on the question of netting enforceability. First, it relates solely to collateral and not to netting rights. More importantly, it deals with the unique question of whether a provision in a structured CDO indenture that purports to reverse the priority of payments in a collateral waterfall based on the insolvency of one creditor is enforceable. The holding of the US bankruptcy court in that decision, and the fact that it reached a different conclusion than the UK courts on the issues presented, ***has nothing to do with collateral enforceability in the ordinary course under a bilateral ISDA Credit Support Annex or similar collateral agreement****, and is not relevant to netting or collateral enforceability determinations. [emphasis added]*

    (b) Allen & Overy commented:

    In Perpetual Trustee Co. Ltd (Lehman Bros Holdings inc et al) v. BNY Corporate Trustee Services Ltd, a court in the US examined the effectiveness of a so-called "flip" clause, which changes the priority of payments between different classes of creditors of a special purpose company upon the insolvency of the senior creditor (in this case, the swap counterparty, LBSF). Flip clauses are commonly used in structured financings but are not part of the standard ISDA Master Agreement or credit support documents used for free-standing trading derivatives transactions. The Court found that the change in priorities upon the swap counterparty's insolvency deprived that party of an asset; that is, that the provisions in the agreement purporting to modify LBSF's right to a priority distribution solely as a result of a Chapter 11 filing constitute unenforceable ipso facto clauses, and that the provisions did not have the benefit of the safe harbors contained in the US Bankruptcy Code with the result that any attempt to enforce such provisions would

> *violate the automatic stay. The Perpetual case, whilst of great interest to the structured finance industry, is not relevant to this discussion because (a) it does not address close-out netting (b)* ***it does not address enforceability of collateral arrangements under the standard ISDA documentation that is used in the market*** *and (c) the provision at issue (a so-called "flip" clause that changes the priority of payments between different classes of creditors of a special purpose company) is not used in ISDA Master Agreements other than with SPV's in structured finance.[emphasis added]*

96. Accordingly, the staff with an alternative view believe that the other staff have not identified a situation where the enforceability of the collateral arrangements under the standard ISDA documentation has been challenged in the jurisdictions where ISDA has obtained a legal opinion. Thus, these staff disagree with the generalizations made about problems with collateral absent specific, on point court decisions.

Views of a Global Financial Institution's Legal Department

97. In July 2010, the staff received information prepared by the associate general counsel of a global financial institution (different from the financial institutions referred to above) that addresses some initial concerns about the enforceability of the ISDA master netting agreement and summarizes the issues involved in some recent legal cases, including the one related to Lehman brothers.

98. The following is an excerpt from that their written correspondence to the staff:

(a) We understand that as part of your consideration of this issue, you have attended presentations given by members and staff of ISDA about the mechanics of Sections 5 and 6 of the ISDA Master Agreement (the "Close Out Netting Provisions"). These presentations outlined the operation of the Close Out Netting Provisions, including how, upon a default and subsequent termination of the Agreement by the Non-defaulting Party, (i) all transactions are terminated ("with no ability on the part of the Non-defaulting Party to selectively terminate or "cherry pick" transactions", (ii) all transactions are valued and the positive value or "in the money" transactions are netted against the negative value or "out of the money" transactions and (iii) the only remaining payment obligation of the parties following termination is to pay the netted termination amount (the "Net Termination Amount"). We also understand that these presentations outlined how the valuation methodology under the Close Out Netting Provisions is intended to assign a value to each transaction which represents its fair value and that the insolvency laws of over 50 jurisdictions, as analyzed by legal opinions commissioned by ISDA, strongly support the enforceability of the Close Out Netting Provisions.

(b) We also understand that you have expressed concerns that litigation arising out of the financial crisis, particularly litigation involving the estate of Lehman Brothers, may call into question the enforceability of the Close Out Netting Provisions. The balance of this background information will demonstrate that this is not the case. Before reviewing the facts and conclusions of some of the cases involving Lehman, it is important to note that the ISDA Master Agreement includes important provisions that parties may use upon a default in addition to the Close

Out Netting Provisions-two provisions in particular are worth mentioning in this context:

i. Section 2(a)(iii), also called the "Mutual Suspense" provision, allows a Non-defaulting Party to suspend its performance, such as making payments, for so long as an event of default is continuing and termination of the contract has not been elected. This provision is intended to provide a means of alleviating transaction issues between the derivative counterparties (e.g., posting by a counterparty of an incorrect collateral balance or incorrect payment amount) through a means other than Close Out, allowing the parties to remedy the situation while providing the non-defaulting party during this period with a suspension of further payments which could increase the non-defaulting counterparty's credit exposure. The Mutual Suspense provision is fundamentally (and legally) different from Close Out netting, which provides for the calculation and payment of a single net Termination Amount in the event that termination is elected after default.

(c) An ISDA Master Agreement also typically contains a "Setoff Provision", which entitles a Non-defaulting Party to set off non-derivative obligations due from the Defaulting Party against the derivative-related single net Close Out Termination Amount owed to the Defaulting Party. For example a Non-Defaulting Party would, under this provision, not pay the net Close Out Termination Amount obligation, but instead use its net obligation to set off against its loans or debt obligation assets issued by the Defaulting Party. Market participants often amend the Set Off Provision to permit set off against payment obligations of affiliates of the counterparty. However, it is important to note that Set Off is a different provision from Close Out netting, and is

considered *after* the Close Out Net Termination Amount is determined.

(d) The cases involving Lehman (and others) have been followed closely by the derivatives bar and have NOT involved issues about the enforceability of the Close Out Netting Provisions of the ISDA Master Agreement. Rather, they have involved issues about (i) the operation of the Mutual Suspense provision, (ii) issues involving the Setoff Provision, particularly affiliate setoff, (iii) the use of certain subordination mechanisms in structured finance transactions or (iv) whether the calculation of individual transaction values was appropriate and in accordance with the restrictions in the Agreement.

(e) A brief description of these cases is as follows:

ii. ***Metavante***. On September 15, 2009 the US Bankruptcy Court hearing the Lehman Chapter 11 bankruptcy cases determined that Metavante Corporation, a swap counterparty of a Lehman debtor, was not excused by reason of the "safe harbor" provisions of the Bankruptcy Code from making scheduled swap payments and, in any event, had waived its right to terminate the swap by taking no action for a year after default. The enforceability of the Close Out Netting Provisions was never in issue in the case. The issue was primarily concerning whether Metavante, the non-defaulting party, could withhold payments due Lehman if Metavante did not terminate the contract. The ruling was that the Metavante had to either elect to terminate or not, but if they elected not to terminate, the contractual right to withhold payment was not protected from US bankruptcy law. As a result, Metavante was required to make payments it owed to Lehman. This ruling was largely a restatement of rulings issued in earlier Enron-related litigation.

iii. ***Perpetual***. The sole issue in the case was the enforceability of the subordination provisions typically present in securitization transactions. Typically, a swap counterparty is senior in the payment priority to the noteholders/creditors in a securitization vehicle. However, if the swap counterparty defaults and upon Close Out is owed money by the securitization vehicle, the ISDA master agreement provides that the defaulting party's interest becomes subordinate to the noteholders/creditors. The preliminary decision holds that the amount owed upon termination to Lehman

as swap counterparty should not be subordinated to noteholders/creditors. The issue is one of entitlement to a Net Termination Amount that was determined, not one concerning the enforceability of the Close Out Netting Provisions of the relevant ISDA Master Agreement.

iv. ***Semcrude/Swedbank***. While unrelated, the Semcrude and Swedbank cases deal with similar issues. They address the isolated question of the requirement for mutuality of obligations to exist in order for a set off right to be exercised in respect of a non-safe-harbored or a safe-harbored transaction respectively. As discussed above, set off rights entitle a Non-defaulting Party, *after* a Net Termination Amount has been calculated, to set off other payment obligations (e.g., loans) arising out of other agreements against the obligation to pay the Net Termination Amount. As in Metavante and Perpetual, both cases address issues that can arise only *after* a Net Termination Amount has been determined and, as such, do not raise issues concerning the enforceability of the Close Out Netting Provisions themselves.

v. ***Nomura***. The ongoing litigation between Lehman and Nomura does not call into question the enforceability of the Close Out Netting Provisions. Instead, this is a dispute regarding the termination values calculated by Nomura, and whether those Net Termination Amounts were appropriately determined in accordance with the terms of the agreement.

Staff Conclusions

99. After considerable research and outreach by the staff, the staff do not agree on the primary question of legal enforceability. Some staff believe that the enforceability of the ISDA master netting arrangements are questionable, thus, should not be included in the criteria for offsetting while others understand that the relevant key provision regarding the non-defaulting parties right to elect to close out net is legally enforceable and that the concept of a legally enforceable right to offset should be considered for inclusion in the criteria of an offsetting model.

Questions for the boards
Do the Boards want to consider legal enforceability for inclusion in the criteria for offsetting?

Do the Boards require more information on this topic? If so, please describe what that information is and why you need it.

Other Contracts Containing Offsetting Provisions

100. Some staff reviewed the financial statement of several major U.S. based financial institutions and inquired of the same about the existence for contractual provisions to offset financial assets and liabilities other than for derivatives pursuant to ISDA master netting agreements or similar netting arrangements with exchanges or clearinghouses. Other than provisions in loan agreements that allow for lenders to offset the loan when it is in default against cash deposits of the borrower that are held at the lender, no other situations were identified. Based upon our inquiries, these staff noted that offsetting provisions were not frequently found in lending agreements. The staff understand that financial institutions rarely attempt to enforce the provisions when they do exist based upon the concept that restricting the debt or otherwise working with the borrower results in a greater realization of the amounts due under the loan than immediately offsetting a loan that is in default against deposits held by the lender. The staff also understand that there is some question of whether the lender may be subject to the claims of other credits such that it would not be automatically able to offset.

101. From its review, the staff noted that financial institutions do not offset deposit against loans under regardless of whether they follow U.S or IFRS GAAP because such arrangements do not meet the offset criteria under both requirements Further, it is the understanding of the staff from its inquires that financial institutions are not seeking the ability to offset such assets and liabilities.

102. Other staff note that offsetting provisions are standard in English and international lending agreements and that such provisions are therefore common in the international banking markets. These staff also noted that banker's right of offset has

been part of English and most common law since the 1800s. The staff notes that under Basle II, financial institutions are allowed to offset loans and deposits.

Staff Conclusions

103. The staff do not believe that until a model for offsetting is tentatively reached by the boards further research of these arrangements described immediately above is beneficial

Question for the boards

Do the Boards agree with the staff's recommendation

If not, do the Boards require more information on this topic? If so, please describe what that information is and why you need it.