EDITORIAL

Can ISDA's Close-out Protocol Stay the Next Lehman Brothers?

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Introduction

The ISDA Master Agreement contains the legal framework which governs the vast majority of global over-the-counter ('OtC') derivative transactions on broadly standardised terms. One of the fundamental principles protected under an ISDA Master Agreement is the right, either automatically or by notice, of a non-defaulting party to terminate and close-out an OtC derivative transaction upon the occurrence of a insolvency default by a counterparty.

Prior to the 2008 Global Financial Crisis it was widely assumed that insolvency defaults triggering termination and close-out provisions under ISDA Master Agreements were most likely to be relied upon by banks following an insolvency default by a non-bank counterparty. The collapse of Lehman Brothers in September 2008, however, changed this view, demonstrating the possibility that a significant global financial institution could fail, causing the simultaneous trigger of insolvency defaults across a large number of ISDA Master Agreements.

Existing English and US principles treat insolvency termination rights of OtC transactions slightly differently. Under English law a party is entitled to terminate a contract on the insolvency of a counterparty as long as the termination does not infringe the anti-deprivation principle, which prohibits a counterparty from exercising rights which have the effect of depriving the defaulting party's estate of any of its assets upon its insolvency. In contrast, under the US Bankruptcy Code (the 'Code'), contractual provisions governed by US law that purport to terminate or modify a contractual term when a party files for bankruptcy (so-called *ipso facto* clauses) are invalid.[1] The effect of this limitation, however, is tempered by certain safe harbour provisions in the Code which allow qualified participants under swap contracts to exercise acceleration, termination and netting rights on the insolvency of a counterparty.[2]

A further area of divergence between English and US principles concerns the enforceability of so-called 'flip-clauses' in swap contracts, under which obligations to swap counterparties are expressed to reverse from a pre-insolvency senior payment position to a post-insolvency subordinated position on the insolvency of the other swap party. Flip clauses were considered by both the UK Supreme Court and the US bankruptcy court in parallel Lehman Brothers' cases in which the UK Supreme Court[3] held such clauses to be effective and the US bankruptcy court[4] found such clauses to be *ipso facto* clauses and therefore invalid under the Code.

Lessons from Lehman Brothers

Since the collapse of Lehman Brothers and the ensuing global financial crisis, policymakers, central banks and regulators have sought to introduce a raft of new legislation designed to assist the resolution and recovery of systemically important financial institutions ('SIFIs'). Such legislation is intended to enable SIFIs that encounter severe financial difficulties to avoid the vagaries and value destruction caused by entering into an uncontrolled cross-border insolvency.

In the US new regulation has been introduced under the Dodd-Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank') which requires designated SIFIs to prepare and maintain resolution plans and provides the US authorities with increased oversight powers in relation to such institutions. Further bank stabilisation and bail-in powers have been introduced in the European Union under the Bank Recovery and Resolution Directive ('BRRD'). The BRRD has largely been implemented in the UK under a series of statutory instruments which amended the Banking Act 2009 with effect from 1 January 2015. In the UK these changes have extended the powers of UK regulatory authorities to intervene directly to stabilise and recapitalise failing deposit-taking SIFIs by cancelling and/or mandatorily transferring certain equity and unsecured instruments issued by such SIFIs prior to the exercise of

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1 Section 365(e)(1) of the US Bankruptcy Code.
2 Section 560 of the US Bankruptcy Code.
3 *Belmont Park Investments PTY Limited v BNY Corporate Trustee Services Limited and Lehman Brothers Special Financing Inc.* [2011] UKSC 38.
4 *Lehman Brothers Special Financing Inc. v BNY Corporate Trustee Services Inc.*, January 25, 2010.

other resolution and recovery tools held by the UK authorities. Such 'bail-in' powers are intended to address the potential moral hazard of a SIFI being deemed 'too big to fail' and the associated risk of tax payers being required to bail-out such institutions should they encounter severe financial difficulties.

Putting aside the ongoing debate as to whether certain SIFIs are too big to fail, one of the lessons learned from the Lehman Brothers' bankruptcy is that non-defaulting counterparties overwhelmingly seek to terminate and close out OtC positions governed by ISDA Master Agreements immediately following the occurrence of an insolvency default by a bank counterparty. Alvarez & Marsal, the restructuring firm that was appointed to manage the Lehman Brothers' estate following its insolvency filing, reported that over 85 percent of Lehman Brothers' ISDA Master Agreements capable of termination were terminated within the first week of its bankruptcy filing[5] costing the Lehman estate 'at least' USD 50 billion.[6]

If it is accepted that the reaction of ISDA Master Agreement counterparties to the bankruptcy of Lehman Brothers is symptomatic of unregulated market behaviour, then it becomes apparent that there is a conflict between:

i. the policy objectives of financial regulators and central banks to steer failing SIFIs to safe resolution and recovery under available special resolution regimes ('SRRs') without triggering the disorderly termination of the applicable SIFI's existing contracts; and
ii. the market behaviour of non-defaulting counterparties, whose instinctive response appears to be to exercise termination rights under ISDA Master Agreements as quickly as possible following an insolvency default of a counterparty.

This conflict has the potential to hinder resolution efforts and disrupt market discipline, which are precisely the types of systemic risks financial regulators and central banks are aiming to avoid in the post-Global Financial Crisis era.

The legislative response

Legislators have attempted to address these conflicting positions by extending existing insolvency moratoria to include the imposition of temporary stays and overrides on any actions by non-defaulting counterparties against a party in resolution, including any actions by counterparties to close out open OtC transactions.

In particular, under the BRRD, European authorities have been granted the power to impose a temporary stay of up to 48 hours[7] on creditor actions and under Dodd-Frank US authorities have the power to impose a one business day stay.[8] The purpose of such temporary stays is to enable a defaulting SIFI and/or its regulators to utilise the stabilisation powers available under applicable SRRs to secure a recovery of the defaulting party outside of insolvency in the period before non-defaulting counterparties are able to terminate and close out OtC transactions. In addition, in the UK, amendments to the Banking Act 2009 now expressly provide that the exercise of crisis prevention measures or a crisis management measure by the UK authorities cannot be used as grounds for counterparties to financial contracts with a failing SIFI, such as OtC transactions governed by ISDA Master Agreements, to exercise early contractual termination rights, unless the SIFI fails to fulfil its substantive obligations under such contracts.[9]

The introduction of temporary stays and prohibitions against the early terminations of financial contracts with SIFIs in resolution is consistent with the overarching policy objective of empowering regulators with resolution and recovery powers to enable a defaulting SIFI to be stabilised and recapitalised in a controlled manner which minimises market disruption. This objective is reflected in The Bank of England's October 2014 publication 'approach to resolution' which states that:

> 'In order for the stabilisation tools to be effective, it must be possible for the Bank [of England] to use them without triggering disorderly termination of the firm's existing contracts. This means that counterparties to financial contracts entered into by the failing firm should not be able to exercise rights to terminate their contracts early. Hence the regime also includes provisions to ensure that a firm's entry into resolution does not, by itself, trigger contractual early termination rights or other events of default.'[10]

However, whilst *prima facie* these legislative measures should act to prevent a non-defaulting party from exercising termination rights under an ISDA Master Agreement against a SIFI in resolution, the purview

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5 EconoMonitor: 'In the Matter of Lehman Brothers – Part 1: Breaking Up is Hard To Do'; 14 November 2011.
6 *The HedgeFund Law Report*: 'Lesson from Lehman Brothers for Hedge Fund Managers: The Effect of a Bankruptcy Filing on the Value of the Debtor's Derivative Book'; Volume 5, Number 27, 12 July 2012.
7 Article 71 BRRD implemented in the UK in Section 70C of the Banking Act 2009.
8 Title 12 U.S.C. 5390(c)(10)(B)(i) Dodd-Frank.
9 Section 48Z of the Banking Act 2009.
10 Paragraph 33 of The Bank of England's approach to resolution, October 2014.

of the applicable domestic legislation is likely to be limited to the jurisdiction in which it is implemented. Consequently, in the context of a cross-border OtC transaction, a domestic stay purportedly preventing the exercise of termination rights under an ISDA Master Agreement may not be recognised or enforceable against a foreign non-defaulting counterparty.

For example, if a UK credit institution was to enter into resolution and its US subsidiary were party to outstanding OtC trades governed by a New York law ISDA Master Agreement with a US counterparty, the stay and overrides under English legislation may not be recognised under New York law in a New York court. In this scenario, the US counterparty may still be able to exercise termination rights under the ISDA Master Agreement and close out the outstanding trades with the subsidiary, notwithstanding the prohibition against such actions under English legislation.

Commenting on this issue, the Financial Markets Law Committee noted in a letter to the Financial Stability Board ('FSB') that:

> 'The interaction between the laws of a resolution forum and the applicable foreign laws governing the contracts, liabilities or assets of a financial institution undergoing resolution proceedings, is a major source of legal uncertainty.'[11]

The ISDA protocol

Acknowledging the potential cross-border vulnerabilities of existing domestic legislation, ISDA, in conjunction with the FSB, introduced the ISDA Resolution Stay Protocol in November 2014 (the 'Protocol'). The Protocol became effective on 1 January 2015 and is intended to provide a framework under which OtC transactions governed by 'Covered Master Agreements', which include ISDA Master Agreements, can be terminated in a controlled, fair and orderly manner.

The Protocol enables parties to amend the terms of ISDA Master Agreements by 'opting-in' to the stay provisions of the SRR applicable to their counterparty (and each related entity of their counterparty), if such SRR is recognised or subsequently adopted under the Protocol[12]. The Protocol thus contractually imposes temporary stay provisions in recognised SRRs to adhering non-defaulting parties to ISDA Master Agreements. In so doing, the Protocol circumvents the recognition and enforcement limitations which potentially hamper the enforcement of temporary stays under domestic legislation. The Protocol applies equally to ISDA Master Agreements with and without automatic termination rights.

Adherence to the Protocol is intended to be permanent, although an adherent may opt to revoke the Protocol by notice during an annual revocation period. The Protocol also contains opt-out provisions if an SRR is amended in a way that negatively affects the enforceability of creditor default rights. In a separate section, the Protocol contains specific provisions which nullify certain default rights if a non-credit enhancement provider counterparty or its affiliates to an ISDA Master Agreement enter into certain US insolvency proceedings.

A crucial feature, and indeed potential shortcoming, of the Protocol is that it is non-binding and relies on both counterparties to an ISDA Master Agreement having voluntarily agreed to adhere to the Protocol by entering into a Protocol agreement with ISDA. ISDA reported that as of 21 November 2014, 115 participants, including 18 banks, have agreed to adhere to the Protocol.[13] According to a FSB press release following the introduction of the Protocol, more than 90 percent of OtC bilateral trading activity will be covered by either contractual or statutory stays.[14] Whilst it is apparent that a SIFI bank may be motivated to adhere to the Protocol due to the mutual benefits provided by adherence, it is less clear why a non-bank counterparty would elect to adhere unless the Protocol is enforced mandatorily.

The end of history?

Notwithstanding the bullishness of the FSB, as the Protocol is effectively a conduit under which temporary stays contained in recognised SRRs are applied to adhering parties, the effectiveness of the Protocol is limited to the remit of the stays existing under the relevant underlying SRRs. This means that a defaulting party which enters into resolution under either a UK or US SRR will only be entitled to a temporary stay period of up to 48 hours or one business day respectively.

Further underlining this point, one of the eligibility conditions in the Protocol for recognising and adopting a new SRR is that the temporary stay period under such new SRR must not exceed two business days.

Such short stay periods provide a defaulting party and its regulatory authorities with very limited time to implement an effective resolution before non-defaulting counterparties are entitled to exercise termination rights under ISDA Master Agreements. The prospect

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11 Letter dated 28 November 2014 from the Financial Markets Law Committee to the Secretariat to the FSB.
12 The Protocol currently recognises SRRs in Germany, Japan, Switzerland, the UK and the US.
13 <www2.isda.org/functional-areas/protocol-management/protocol-adherence/20>.
14 <www.financialstabilityboard.org/2014/10/pr_141011/>.

of achieving a successful recovery of a defaulting SIFI during the limited time available under applicable temporary stay periods is therefore far from certain. Advocates for the Protocol, however, are likely to argue that a limited stay is better than no stay and could provide regulatory authorities with sufficient time to implement an expedited recovery of a failing SIFI over a weekend whilst the markets are closed. If successful, such an arrangement would potentially satisfy the goal set by policymakers and central banks for recovery regimes to be introduced which facilitate the restoration of SIFIs with minimal market disruption and without recourse to tax payer resources.

The temporary stays contained in SRRs and adopted under the Protocol therefore are a step in the right direction. However, absent longer stay periods and the extension of similar extraterritorial principles to those contained in the Protocol to other domestic legislative prohibitions on the exercise of termination and close out rights against SIFIs in resolution, may mean that the possibility of 'another Lehman Brothers' has not yet been consigned to the history books.

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