

**IN THE COURT OF APPEAL (CIVIL
DIVISION)**

**A2/2011/0070, A2/2011/1059, A3/2011/1107
& A3/2011/2106**

**ON APPEAL FROM THE HIGH COURT
OF JUSTICE (QUEEN'S BENCH
DIVISION, COMMERCIAL COURT)**

**SECOND WRITTEN
SUBMISSIONS ON BEHALF
OF THE INTERNATIONAL
SWAPS AND DERIVATIVES
ASSOCIATION, INC.
("ISDA")**

In these submissions, unless the contrary is stated: (a) references to Sections are to those of the 1992 ISDA Master Agreement (Multicurrency – Cross Border) and the ISDA 2002 Master Agreement (together, the ‘Master Agreements’); and (b) capitalised terms refer to definitions used in those agreements.

A. Introduction

1. On 6 September 2011, the Court of Appeal (Longmore LJ) directed that four appeals, which all concern the consequences of the occurrence of an Event of Default under the Master Agreements, are to be heard to together:
 - (1) an appeal brought by the administrators (the ‘Administrators’) of Lehman Brothers International (Europe) (‘LBIE’), which was Defaulting Party in relation to a series of interest rate swaps, against an order of Briggs J dated 21 December 2010 in Lomas v. Firth Rixson [2010] EWHC 3372 (Ch) (the “LBIE appeal”).

- (2) an appeal by Lehman Brothers Special Financing Inc, a Delaware incorporated company subject to Chapter 11 of the US Bankruptcy Code, which was the Defaulting Party in relation to two interest rate swaps, against an order of Briggs J dated 28 March 2011 in LBSF v Carlton Communications [2011] EWHC 718 (Ch) (the “LBSF appeal”).
 - (3) an appeal by Pioneer Navigation Limited and Atlas Shipping Limited, as the Non-defaulting Party under a series of forward freight agreements (“FFAs”), incorporating the 1992 ISDA Master Agreement, against an order made by Flaux J dated 25 March 2011 in respect of a preliminary issue in Britannia Bulk plc v. Pioneer Navigation [2011] EWHC 692 (Comm) (the “Britannia Bulk appeal”)
 - (4) an appeal by Pioneer Freight Futures Company Limited as the Defaulting Party under a further series of FFAs, against an order made by Flaux J dated 5 July 2011 in Pioneer Freight Futures Company v. Cosco Bulk Carrier [2011] EWHC 1692 (Comm) (the “Pioneer appeal”).
2. ISDA was granted permission by Arden LJ on 12 August 2011 to intervene in the LBIE and LBSF appeals by way of written submissions, but was refused permission to appear by Counsel at the hearing of those appeals. ISDA now seeks permission (a) to intervene in the Britannia Bulk and Pioneer appeals by making these further written submissions and (b) to appear by Counsel at the hearing of the combined appeals. In either case, ISDA’s application to intervene is on the basis that it is liable to pay its own costs and is not liable, provided it acts reasonably, to pay the costs of any other party.
3. Common to all four appeals is the effect of Section 2(a)(iii) of the Master Agreement. In the LBIE and LBSF appeals, Section 2(a)(iii) falls to be considered in circumstances where no Early Termination Date has been

designated. In the Britannia Bulk and Pioneer appeals, on the other hand, it falls to be considered in the context of the occurrence of an Early Termination Date under Section 6¹.

4. This reflects the two distinct regimes under the Master Agreement which apply depending on whether an Early Termination Date has occurred.
 - (1) Prior to the occurrence of an Early Termination Date the payment or delivery obligations of the parties under the potentially numerous Transactions contemplated by a Master Agreement are governed substantively by Section 2. In particular, Section 2(a)(i) provides that, subject to the other provisions of the Master Agreement, each party will make each payment or delivery specified in each Confirmation to be made by it.
 - (2) Following an Early Termination Date (whether as a result of the parties having opted for Automatic Early Termination to apply or as a result of one party choosing to designate an Early Termination Date following an Event of Default by the other party), however, the parties' various obligations under Section 2(a)(i) are brought to an end, and replaced with (at most) a single payment obligation to be made by one party or the other, which is to be determined pursuant to Section 6(e). This is often referred to as close-out netting. Close-out netting is a fundamental aspect of the Master Agreement, important in reducing the risks associated with derivatives for the benefit of both parties, by ensuring that both parties' credit exposure from the other's default is net, not gross.

ISDA's position on the issues on appeal

¹ Both of these cases concern the 1992 Master Agreement. The formulation of the close-out calculation under Section 6 was amended in the 2002 Master Agreement.

5. ISDA, which appeared before the Judge in the LBIE appeal, has already made written submissions focusing on two issues arising out of the LBIE appeal dated 29 July 2011 (“ISDA’s LBIE Submissions”), in which it submits²:
 - (1) (at Section C) that Briggs J was correct that a Non-defaulting Party’s obligations to pay or deliver under Section 2(a)(i) are not extinguished merely because an Event of Default exists on the date specified for performance in the Confirmation in question (the “suspension/extinction” issue).
 - (2) (at Section D) that Briggs J was wrong to hold both that a Transaction “expires by effluxion of time” on the date upon which the last in time of the obligations under Section 2(a)(i) was due for performance (there being no such concept under the Master Agreement), and that a Non-defaulting Party’s unperformed obligations to pay or deliver under Section 2(a)(i) were thus extinguished when an Event of Default exists at that date (the “effluxion of time” issue).
6. In both the Britannia Bulk and Pioneer appeals an Early Termination Date was triggered by Automatic Early Termination, the parties having made that election in the FFAs, and Loss and Second Method were agreed to apply. The focus of the Britannia Bulk and Pioneer appeals is on close-out under Section 6(e), that is, the determination of the amount, if any, payable in respect of an Early Termination Date.
7. In Pioneer, Flaux J, accepting the submissions of the Non-defaulting Party, held that the close-out netting calculation under Section 6 excluded Transactions “which have already terminated at their natural expiry date” (at [103]). In particular, two categories of obligation under such Transactions that were unperformed on the Early Termination Date were excluded.

² These submissions are prepared on the basis that ISDA’s LBIE Submissions are read first.

- (1) Applying and extending Briggs J's reasoning to a close-out under Section 6, *Flaux J* held that a Non-defaulting Party's unperformed obligations under Transactions which had "expired by effluxion of time" were excluded. Thus, where a Transaction would have resulted in a sum falling due to the Defaulting Party, but for the effect of Section 2(a)(iii), any obligation owed by the Non-defaulting Party was extinguished if the Event of Default was continuing on the final date for performance of any obligation specified in the relevant Confirmation, and for that reason was irrelevant to the calculation of the amount due under Section 6.
 - (2) Where, as at an Early Termination Date, a Non-defaulting Party had an accrued but unpaid right to payment of a debt under Section 2(a), under a Transaction that had "expired by effluxion of time", then although the right subsisted, it was not subject to the close-out calculation.
8. ISDA submits that this analysis of the scope of the close-out required under Section 6 is incorrect. The correct analysis, set out in Section C below, is that:
 - (1) Absent any provision to the contrary in a particular Confirmation, the effect of the Master Agreement is that obligations to pay or deliver under Section 2(a)(i) are only discharged (absent agreement) if performed or upon the occurrence or effective designation of an Early Termination Date (in which latter case they are replaced by an obligation to pay the amount determined under Section 6(e)): see Section D of ISDA's LBIE Submissions.
 - (2) Where an Early Termination Date occurs following an Event of Default the close-out mechanism provides a comprehensive regime covering all unperformed obligations arising under Section 2(a) and under the default interest provision in Section 2(e) of the 1992 Master

Agreement³ in all Transactions governed by the Master Agreement in question.

- (3) It is irrelevant if, under a particular Transaction, the last date specified in the Confirmation for performance of the payment or delivery obligations under Section 2(a)(i) has passed. Provided that any of those obligations remain unperformed (whether because of the operation of Section 2(a)(iii) or because they have fallen due but remain unperformed) then the close-out mechanism extends to include those Transactions under which they arise.
 - (4) Accordingly, in relation to each such unperformed obligation, the occurrence of an Early Termination Date results in that obligation:
 - (a) no longer requiring to be made (as provided by Section 2(a)(iii)(2) and Section 6(c)(ii)); but
 - (b) being taken into account in calculating the single obligation that replaces all of them, namely the payment (if any) due under Section 6(e).
9. In Britannia Bulk, Flaux J rejected an argument by the Non-defaulting Party (labelled the “nil loss” argument) that it was required to pay nothing to the Defaulting Party pursuant to its calculation of its Loss under Section 6(e), because had no Early Termination Date occurred, then, because of the continuing Event of Default, the effect of Section 2(a)(iii) would have been

³ Where a party defaults in the performance of any payment obligation, Section 2(e) (and Section 9(h)(i) of the 2002 Master Agreement) requires interest to be paid to the Non-defaulting Party at the Default Rate, until any Early Termination Date. Section 9(h)(i)(3) of the 2002 Master Agreement also requires the Non-defaulting Party to pay interest at a non-default rate (basically, its cost of funding) on any amount that did not become due on its scheduled due date as a result of Section 2(a)(iii) (or certain other provisions) where such an amount subsequently becomes due (in the case of Section 2(a)(iii) as a result of the fulfilment of the conditions subsequent) prior to the Early Termination Date.

that it would not have been required to make any payments to the Defaulting Party. ISDA contends, as set out in Section D below, that Flaux J's conclusion was correct.

10. Before addressing the specific points raised respectively by the Pioneer and Britannia Bulk appeals, it may be helpful to explain the general provisions that underpin Section 6 of the Master Agreement.

B. Close-out under Section 6

11. First, it must be emphasised that the operation of the close-out netting mechanism under Section 6, especially where one of the parties is affected by an Event of Default, is of fundamental importance to the Master Agreement, to the derivatives market generally and to the regulation of financial institutions that participate in it. In particular, a crucial aim of close-out netting is to reduce both parties' potential exposure to credit risk from gross exposure to net exposure: see para 19 of ISDA's LBIE submissions. The "single most important technique for reducing credit risk in the OTC derivatives market is contractual termination and close-out netting".⁴
12. Secondly, at the time of entering a Master Agreement, the parties cannot know which (if either) of them will be affected by an Event of Default. Accordingly, they agree that the close-out mechanism will apply equally, whichever of them is later affected by an Event of Default, so that, from the moment of executing the Master Agreement, the credit exposure of both is limited to net exposure.
13. Thirdly, the close-out mechanism uses certain concepts, such as "Terminated Transactions", not because it is intended to limit the effect of an Early Termination Date following an Event of Default, and thus the scope of close-

⁴ Henderson on Derivatives (2nd ed), para 11.1.

out netting in that context, but because an Early Termination Date may follow either an Event of Default or a Termination Event. As a result, an Early Termination Date may have a different breadth of effect under the Master Agreement:

- (1) Where an Early Termination Date follows a Termination Event consisting of an Illegality, Tax Event, Tax Event upon Merger or (only under the 2002 Master Agreement) Force Majeure Event, it extends only to those Transactions affected by the occurrence of the Termination Event, so that other Transactions governed by the Master Agreement are unaffected by the occurrence of the Early Termination Date.
- (2) By contrast, following an Event of Default (or, for that matter, any other Termination Event) it extends to all Transactions. In other words, all Transactions stand or fall together for most purposes, particularly in relation to a default, and this is considered commercially an important corollary of the single agreement referred to in Section 1(c).

While the current appeals concern Early Termination Dates that followed an Event of Default, and that is the subject matter of the submissions that follow, it must be remembered when looking at its wording that Section 6 is designed to accommodate both situations. Thus, the scope of “Terminated Transactions” varies, depending on the cause of the Early Termination Date:

“‘Terminated Transactions’ means with respect to any Early Termination Date (a) if resulting from a Termination Event, all Affected Transactions and (b) if resulting from an Event of Default, all Transactions (in either case) in effect immediately before the effectiveness of the notice designating that Early Termination Date (or,

if 'Automatic Early Termination' applies, immediately before that Early Termination Date). ”⁵

14. Fourthly, the close-out mechanism is designed to deal robustly with numerous different types of derivative transactions in a manner which can be performed by market participants. In fact, it is designed to be sufficiently broad and flexible that it can encompass any derivative transaction of any nature relating to any underlying asset, index or other variable measure, whether cash-settled (that is, solely by payment by one or both parties) or physically settled (that is, by delivery by at least one party of a security, commodity or other form of asset).

15. Fifthly, where an Early Termination Date occurs, the numerous Transactions entered into between the parties under the Master Agreement will probably be in varying stages of performance. For example:
 - (1) At one end of the scale, there may be Transactions which have been completely performed by the Early Termination Date, or unwound by agreement, so that no further payment or delivery obligations can arise either way.

 - (2) At the other end of the scale, there may be Transactions where the Early Termination Date occurs before the time specified for any payment or delivery obligations had been reached, so that all such obligations under Section 2 are prospective.

 - (3) Alternatively, the Early Termination Date might have occurred at a time when payment or delivery obligations under other Transactions have already accrued due under Section 2(a), but have not been

⁵ This definition is taken from the 1992 Master Agreement. The corresponding definition in the 2002 Master Agreement is substantially the same.

performed. For example, the Defaulting Party may have failed to make payments that fell due under Section 2(a)(i), so triggering the Event of Default.

- (4) In relation to other Transactions, the Non-defaulting Party might already have been required to make payments but for the effect of Section 2(a)(iii).
 - (5) There could be some Transactions encompassing amounts falling within both of (3) and (4).
16. Sixthly, Section 6 operates by replacing all the different rights and obligations arising under Section 2(a)(i), together with any under the default interest provision in Section 2(e), with a single payment obligation to be determined under Section 6(e): see Section 6(c)(ii).
17. Seventhly, the rights to be taken into account in calculating the sum payable following an Early Termination Date fall into three broad categories. The User's Guide to the 1992 ISDA Master Agreements⁶ identifies (at 26) three components of the payment to be made on the occurrence of an Early Termination Date:

“Under the 1992 Agreements a payment on early termination can be viewed as consisting of the following three components: (i) payments for obligations which became payable or deliverable but which were not paid or delivered prior to the Early Termination Date, (ii) payments for obligations which would have been payable or deliverable prior to the Early Termination Date if all conditions to payment or delivery (such as the absence of any Event of Default) had been satisfied or if the Early Termination Date had not been

⁶ This is a booklet, published by ISDA in 1993, which is designed, as its Introduction sets out, to explain the 1992 Agreements (there was also a US dollar only version of the 1992 Agreement) and to highlight significant changes from 1987 Agreement. It also identifies and discusses certain issues that merit additional consideration by market participants.

designated and (iii) payments for the future value of the Terminated Transactions or the Agreement, as the case may be. The amounts referred to in clauses (i) and (ii) are included in the definition of 'Unpaid Amounts'. Amounts referred to in clause (iii) are referred to in the definition of 'Market Quotation'. Amounts referred to in clauses (i)-(iii) are encompassed within the definition of 'Loss'."

18. Eighthly, the Master Agreement expressly provides that obligations owed by the Non-defaulting Party to the Defaulting Party, which had not accrued due by the Early Termination Date because a condition precedent had not been fulfilled, together with interest up to the Early Termination Date, are to be taken into account in calculating the sum due in the context of close-out netting, whether under Market Quotation or Loss in the 1992 Master Agreement:⁷

(1) Where Market Quotation is applicable, such obligations are included in the definition of "Unpaid Amounts" (underlining added):

"'Unpaid Amounts' owing to any party means, with respect to an Early Termination Date, the aggregate of (a) in respect of all Terminated Transactions, the amounts that became payable (or that would have become payable but for Section 2(a)(iii)) to such party under Section 2(a)(i) on or prior to such Early Termination Date and which remain unpaid as at such Early Termination Date and (b) in respect of each Terminated Transaction, for each obligation under Section 2(a)(i) which was (or would have been but for Section 2(a)(iii)) required to be settled by delivery to such party on or prior to such Early Termination Date and which has not been so settled as at such Early Termination Date, an amount equal to the fair market value of that which was (or would have been) required to be delivered as of the originally scheduled date for delivery, in each case together with (to the extent permitted under applicable law) interest, in the currency of such amounts, from (and including) the date such amounts or obligations were or

⁷ Similarly, in calculating the Close-out Amount under the 2002 Master Agreement, obligations owed by the Non-defaulting Party to the Defaulting Party, which had not accrued due by the Early Termination Date because a condition precedent had not been fulfilled, together with interest up to the Early Termination Date, are "Unpaid Amounts"

would have been required to have been paid or performed to (but excluding) such Early Termination Date, at the Applicable Rate. Such amounts of interest will be calculated on the basis of daily compounding and the actual number of days elapsed. The fair market value of any obligation referred to in clause (b) above shall be reasonably determined by the party obliged to make the determination under Section 6(e) or, if each party is so obliged, it shall be the average of the Termination Currency Equivalents of the fair market values reasonably determined by both parties.”

- (2) In the case of Loss, a single amount is determined, to include both the future value of the Terminated Transactions and payments that accrued (or would have accrued) prior to the Early Termination Date. The second sentence of the definition of Loss is in the following terms (underlining added):

“Loss includes losses and costs (or gains) in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date and not made, except, so as to avoid duplication, if Section 6(e)(i)(1) or (3) or 6(e)(ii)(2)(A) applies.⁸”

19. Thus, it is clear both in relation to Market Quotation and Loss under the 1992 Master Agreement that, when it performs a close-out calculation, a Non-defaulting Party cannot exclude sums that it would have been required to pay the Defaulting Party under a Transaction, merely because, at the time specified for performance of the obligation, there was a continuing Event of Default (or Potential Event of Default). Under neither Master Agreement is any distinction drawn between Transactions where the last date specified for payment or delivery has passed, and those where it has not.

⁸ This refers to the situation where Market Quotation has been specified but is impossible or produces a commercially unreasonable result, so that the Loss measure is applied as a fall-back: see the definition of Settlement Amount. Because Market Quotation already takes into account these obligations as Unpaid Amounts, they are excluded from the fall-back Loss calculation to prevent double counting.

20. Ninthly, while the close-out provisions are sufficiently broad to include all three components identified above (i.e. accrued rights, rights subject to a condition precedent and future rights as at the Early Termination Date), they could not and do not assume that all three components will be present in relation to all Transactions. Rather, it will depend on the relationship between the Early Termination Date and the dates specified in the Confirmations. For example, it is possible that at the Early Termination Date there were no amounts that had accrued due, or would have accrued but for the condition precedent, so that the only component would be in respect of future obligations. On the other hand, it may be that there were no future obligations as at the Early Termination Date so that the only payments would be in respect of obligations that had already fallen due.

C. The Pioneer appeal

21. On 14 December 2009, Pioneer resolved to go into voluntary liquidation. By then, Pioneer had entered 11 FFAs with Cosco. Pioneer's resolution was an Event of Default, which automatically triggered an Early Termination Date.
22. In none of the 11 Transactions had all obligations specified in the Confirmation been performed by 14 December 2009, or unwound by agreement. On the contrary:
- (1) In relation to four Transactions, where the last contract month (i.e. the last date specified for payment) was December 2008, the Defaulting Party, Pioneer, had failed to pay sums that had accrued due to Cosco (at [14]).
 - (2) In relation to the next four Transactions, where the last contract month was (in two cases) December 2008 and (in the other two) March 2009, Cosco had not paid sums that would have accrued due to Pioneer, but for the fact that Pioneer was at that time subject to an Event of Default

or Potential Event of Default, so that Cosco could rely on Section 2(a)(iii) (at [13]).

(3) In relation to final three Transactions, the last contract month was after the Early Termination Date. Pioneer was “in the money” in those Transactions, the total sum being derived (presumably) from two components:

(a) Sums that would have accrued due to Pioneer prior to 14 December 2009, but for it being affected by an Event of Default; and

(b) The value of the payments it would have received for contract months falling after 14 December 2009.

23. In this factual context, ISDA contends, in accordance with the general points made under Section B above in relation to Section 6 of the Master Agreement, that the close-out mechanism results in all unperformed obligations of each party under each of the above Transactions being replaced by a single net payment obligation calculated in accordance with Section 6(e). This is supported by the language and structure of the Master Agreements, together with commercial considerations, in particular the importance of close-out netting in reducing exposure in derivative transactions.

24. Flaux J, however, reached a different conclusion, and found that one category of Transaction was excluded from the close-out mechanism in Section 6 altogether, namely a Transaction where the last date for performance had passed prior to the Early Termination Date. Accordingly, he held, any unperformed obligation under such a Transaction, including obligations that had accrued to Cosco, but not been paid by Pioneer, and obligations that would have accrued to Pioneer but for the operation of Section 2(a)(iii) upon

Pioneer becoming subject to an Event of Default, were not to be taken into account in arriving at the net sum payable under Section 6(e).

25. ISDA respectfully contends that Flaux J's reasons for this conclusion do not withstand scrutiny.
26. First, the consequence of Flaux J's reasoning is to undermine a central function of close-out netting under Section 6, namely to reduce the credit exposure of both parties to a net exposure across all Transactions entered into under the Master Agreement. Flaux J's approach contradicts the overriding purpose of the close-out mechanism, to ensure comprehensive netting between obligations arising under Transactions covered by a Master Agreement. This is seen most acutely in the fact that on Flaux J's analysis accrued, but unpaid, obligations fall outside the close-out mechanism. Commercially rational parties, who will not know at the time they enter a Master Agreement whether they would benefit, or suffer, from a partial close-out along the lines suggested by Flaux J, will want an agreement that generally limits their credit exposure in so far as possible. That is achieved by a comprehensive close-out.
27. Secondly, at the heart of Flaux J's approach is the concept of Transactions governed by a Master Agreement "expiring by effluxion of time". There is no such concept expressly recognised under the Master Agreement, nor is there any basis to imply such a concept: see section D of ISDA's LBIE Submissions.
28. Thirdly, there is no commercial or logical justification for distinguishing between an obligation which remains unperformed as at the Early Termination Date, because of the operation of Section 2(a)(iii), where the last date for performance under the relevant Transaction has not arrived, and that which remains unperformed due to the operation of Section 2(a)(iii) where the last date for performance under the relevant Transaction has passed. On Flaux J's

approach, however, the former is included in, but the latter excluded from, the close-out mechanism.

29. Fourthly, Flaux J was wrong to conclude that the phrases “all outstanding Transactions” (in Section 6(a)) and “all Transactions in effect” (in the definition of Terminated Transactions, used in Section 6(ii)(e)) implied that Transactions where the last date specified for performance of obligations to pay or deliver had passed were excluded from the close-out mechanism following an Event of Default. The phrases do not carry the implication ascribed to them by Flaux J.

(1) The primary function of both phrases (see, in particular, the use of the word “all”) is to ensure that, in the case of an Early Termination Date consequent upon an Event of Default, the close-out mechanism deals comprehensively, to the extent that it is necessary to do so, with all Transactions pursuant to the Master Agreement. This has the effect that (a) there will remain no Transactions to which Section 2(a) continues to apply and (b) all unperformed obligations under any Transactions will be included within the close-out netting mechanism. This accords with the general objective of preventing cherry-picking by a liquidator of particular Transactions outside a close-out: see para 20 of ISDA’s LBIE Submissions.

(2) The words “outstanding” and “in effect” simply reflect the fact that there may well be Transactions entered into under the umbrella of the Master Agreement which have been fully performed or unwound by agreement. The use of those words does not suggest that Transactions under which there are unperformed obligations fall through the net.

(3) The fact that obligations that would have accrued but for Section 2(a)(iii) are expressly referred to in the definition of Unpaid Amounts (where Market Quotation under the 1992 Master Agreement or

Close-out Amount under the 2002 Master Agreement applies) and the definition of Loss (where Loss under the 1992 Master Agreement applies) is powerful support for the conclusion that the definition of Terminated Transactions includes Transactions which would have been fully performed but for the operation of Section 2(a)(iii) (i.e. Transactions under which the last date for performance has passed, but where performance of certain obligations, including the last in time obligation, remain unperformed because of a continuing Event of Default).

30. Fifthly, Flaux J's approach is inconsistent with the "*Single Agreement*" provision in Section 1(c):

- (1) The effect of Section 1(c) is that the parties are agreeing that the obligations contained in "*all Transactions ... entered into*" (underlining added) are not to be treated as separate and distinct, but are made subject to the common contractual framework constituted by the Master Agreement, including when an Early Termination Date occurs. This is re-inforced and emphasised by the statement that "*the parties would not otherwise enter into any Transactions*" (underlining added).
- (2) Indeed, Flaux J rightly accepted (at [68]) that Section 1(c) served to facilitate set-off (strictly, netting) of obligations between different Transactions subject to the same Master Agreement, and to ensure that all Transactions would be subject to a single Event of Default.
- (3) The main difficulty in Flaux J's approach to close-out netting is that, contrary to what the parties have agreed in Section 1(c), their various Transactions are not all treated in the same way, but are treated differently, some being made part of the netting under Section 6, and others being excluded.

- (4) More specifically, Flaux J’s suggestion (at [68], last sentence) that “*the Single Agreement provision is saying nothing about which transactions form part of that single agreement*” is wrong. Section 1(c), which must be read in light of the introductory words to the Master Agreement, expressly states that the “*single agreement*” includes “all Transactions” and “all Confirmations” (underling added), that is all “*the documents and other confirming evidence ... exchanged between the parties confirming those Transactions.*” The repeated use of the word “*all*” makes the broad intended scope of the single agreement plain. There is no hint that any category of Transaction is intended to be excluded.
- (5) In that context, Flaux J’s construction (in [70]) of Section 1(c) as extending, on an Early Termination Date, only to that class of Transactions where there are future dates for payment or delivery obligations specified is both unjustified by wording of Section 1(c), and contrary to its purpose. There is no basis for this implied limitation on the scope of the single agreement which is one of the main pillars on which the ISDA Master Agreement architecture is built.
31. Sixthly, Flaux J was wrong to rely upon the reference to “Set-off” in Section 6(e) to conclude that “*the Master Agreement expressly recognises that there may be sums owing under the Master Agreement, without their being the subject of the close-out calculation*” (see [102], adopting a submission of Cosco at [46]). The Master Agreement does no such thing.
32. The relevant provisions are:
- (1) The last sentence of Section 6(e), prior to sub-sections (i) to (iv), which says “*The amount, if any, payable in respect of an Early Termination Date and determined pursuant to this Section will be subject to any Set-off*”; and

- (2) Section 14, which provides that Set-off means “*set-off, offset, combination of accounts, right of retention or withholding or similar right or requirement to which the payer of an amount under Section 6 is entitled or subject (whether arising under this Agreement, another contract, applicable law or otherwise) that is exercised by, or imposed on, such payer.*”
33. Flaux J relied on the phrase “*whether arising under this Agreement...*” in Section 14 to conclude that the draftsman contemplated that there could be a set-off, against the net payment due under Section 6, of other rights arising under the same Master Agreement, thereby contemplating that such rights might exist notwithstanding close-out netting and, as such, indicating that the draftsman cannot have regarded the close out as comprehensively dealing with all unperformed obligations under the Master Agreement.
34. This reasoning is flawed. When considering set-off, it is important to distinguish between two distinct elements, (a) the underlying cross-claims between the parties and (b) any right to discharge those cross-claims by way of a set-off, whether arising by contractual agreement, or under the general law. Contrary to Flaux J, the phrase “*arising under this Agreement*” refers not to an underlying claim arising under the Master Agreement which a party seeks to set-off against the obligation arising under Section 6(e), but to a right to discharge cross-claims by way a set-off arising under the Master Agreement. More specifically, the set-off contemplated by Section 6(e) is a set-off between (a) the right to payment arising under Section 6(e) and (b) a right to payment arising under any other agreement (i.e. outside the ambit of the Master Agreement) between the parties. This is demonstrated by two points.
35. First, it is clear from the remaining words in parentheses in the definition in Section 14: “*whether arising under this Agreement, another contract, applicable law or otherwise*”. In particular, a right arising under “*applicable*

law” is apt to refer only to a right of set-off (and is intended to refer to, e.g., a right of set off arising under a relevant insolvency law), as opposed to an underlying right to payment which it is sought to set-off against the Section 6 right.

36. Secondly, it appears from the following:

- (1) The 1992 Master Agreement, in un-amended form, does not include any set-off agreement between the parties.⁹ For example, it does not include any agreement permitting or requiring set-off arising out of other agreements between the same parties.¹⁰
- (2) However, as the User’s Guide to the 1992 ISDA Master Agreement explains (at 54 to 60), ISDA included the reference to set-off in Section 6(e) because it contemplated that parties might well wish to include a set-off agreement in their Schedule to the Master Agreement, especially where Second Method had been selected. It also included a draft “*Basic Set-Off Provision*” (at 56¹¹).

⁹ Neither Section 2(c), dealing with payment netting, nor Section 6(e), dealing with close-out netting is properly characterised as a set-off agreement. Those sections instead determine the scope of the obligations that arise.

¹⁰ By contrast, a set-off provision, based on the Basic Set Off provision in the 1992 User’s Guide, is included (as Section 6(f)) in the 2002 Master Agreement (at 29).

¹¹ The first paragraph of the Basic Set-Off Provision, in so far as it applies on an Event of Default, is in the following terms: “**(f) Set-off.** Any amount (the ‘Early Termination Amount’) payable to one party (the ‘Payee’) under Section 6(e), in circumstances where there is a Defaulting Party ... will, at the option of the party (‘X’) other than the Defaulting Party ... (and without prior notice to the Defaulting Party ...), be reduced by its set-off against any amount(s) (the ‘Other Agreement Amount’) payable (whether at such time or in the future or upon the occurrence of a contingency) by the Payee to the Payer (irrespective of the currency, place of payment or booking office of the obligation) under any other agreement(s) between the Payee and the Payer or instrument(s) or undertaking(s) issued or executed by one party to, or in favour of, the other party (and the Other Agreement Amount will be discharged promptly and in all respects to the extent it is so set-off). X will give notice to the other party of any set-off effected under this Part 5(a).”

- (3) The User's Guide explained the importance of set-off (underlining added):¹²

“Parties may wish to consider the inclusion of a set-off clause in their 1992 Agreement. In Section 6(e) of the 1992 Agreement, there is a reference to Set-off designed to make clear that payments due in respect of an Early Termination Date will be subject to any ‘Set-off’ (as defined). Parties may use this reference as the avenue for augmenting a 1992 Agreement in the Schedule by adding a form of set-off clause they find acceptable. Set-off may be of particular importance in the case of a 1992 Agreement that provides for the Second Method because, without an effective set-off clause, the Non-Defaulting Party might be required to make payment under a 1992 Agreement upon termination while, at the same time, the Non-defaulting Party may not have any realistic expectation of receiving payments owed to it by the Defaulting Party (and its Affiliates) under other agreements.”

37. The reference to set-off in Section 6(e) of the 1992 Master Agreement therefore does not support Flaux J’s conclusion as to the limited scope of the close-out calculation.

D. The Britannia Bulk appeal

38. The “nil loss” argument seeks to exclude, from a Non-defaulting Party’s determination of its Loss under Section 6(a), the amount of any gains made by that party as a result of the Early Termination Date bringing to an end its future payment or delivery obligations under Section 2(a)(i) on the basis that, because the Defaulting Party continued to be affected by an Event of Default,

¹² An example of the importance of the effect of an incorporation of a set-off clause in a Master Agreement is the recent decision of Field J in Lehman Brothers Commodity Services v. Credit Agricole [2011] EWHC (Comm) 1390, esp at [4], [17] and [35] to [36] which concerned a New York law governed ISDA Master Agreement. A set-off provision included in the Schedule to the Master Agreement allowed Calyon, the Non-defaulting Party in that case, to set off against an obligation it owed to the Defaulting Party as issuing bank under an unrelated letter of credit.

the condition precedents to those obligations in Section 2(a)(iii) could never, in fact, have been fulfilled.

39. The “nil loss” argument has been rejected both by Flaux J, in Britannia Bulk and by Gloster J in Pioneer Freight Futures Ltd v. TMT Asia Ltd [2011] EWHC 778 (Comm), at [109] to [117].¹³
40. ISDA respectfully submits that Flaux J and Gloster J were correct.

E. Conclusion

41. For the reasons set out above and in ISDA’s LBIE Submissions, ISDA supports the appeal against Flaux J’s determination in Pioneer that certain of the Transactions were to be excluded from the Non-defaulting Party’s determination its loss, but supports the determination reached by Flaux J in Britannia Bulk.

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25 October 2011

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¹³ In TMT Asia the Non-defaulting Party went further, contending that even past obligations which would have arisen prior to the Early Termination Date but for Section 2(a)(iii) were to be excluded from its Loss calculation: see [109] to [117].