

The ISDA Master Agreement - Rights of the Defaulting Party under Danish insolvency law

1 Background

In the, now famous, Australian (New South Wales) High Court decision in *Enron, Australia vs. TXU Electricity Ltd.*¹, the Australian Court found that, upon a Bankruptcy Event of Default² occurring under an ISDA Master Agreement between Enron Australia ("**Enron**") and TXU Electricity Ltd. ("**TXU**") in respect of Enron, TXU, as the Non-defaulting Party, could, but was not obliged to, designate an Early Termination Date under the ISDA Master Agreement³.

The Transactions entered into between the parties under the ISDA Master Agreement between TXU and Enron had developed such that had TXU terminated, it would have been required to compensate Enron's loss as Enron was "in-the-money" at the time of its default. TXU chose not to terminate.

Further, on the basis of the condition precedent in Section 2(a)(iii) of the ISDA Master Agreement, pursuant to which no payments or deliveries need to be made by a party if the other party is in default,⁴ TXU was not obliged to, and did not, make any further payments or deliveries to Enron under the relevant Transactions.

Invoking Australian insolvency legislation, which allows an insolvency estate to disaffirm beneficial contracts with the leave of court, Enron sought to obtain the leave of the court to liquidate the Transactions with TXU. The New South Wales

¹ *Enron Australia vs. TXU Electricity Ltd.* [2003] NSWSC 1169.

² Cf. Section 5(a)(vii) of the 2002 ISDA Master Agreement. Capitalised terms used in this article have the meaning given to them in the 2002 ISDA Master Agreement, and references to the ISDA Master Agreement in this article are to the 2002 version thereof.

³ Cf. Section 6(a) of the ISDA Master Agreement.

⁴ The provision reads: "*Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each of the conditions specified in the Agreement to be a condition precedent for the purpose of this Section 2(a)(iii).*"

High Court, however, refused to grant such leave and upheld the contractual right of TXU **not** to terminate the Transactions under the ISDA Master Agreement and **not** to make any further payments thereunder to Enron.

2 Investigation

The question which interests the authors of this article (and may also interest those who have or intend to enter into ISDA Master Agreements with Danish counterparties), is: *If faced with the same questions as those faced by the Australian court in TXU vs. Enron, what result would a Danish court reach?*

The answer to this question depends on whether, upon the insolvency of a Danish party to an ISDA Master Agreement, which is in-the-money, either:

- 1) the non-insolvent party (Non-defaulting Party) may, in accordance with Section 6(a) of the ISDA Master Agreement and in reliance on the Section 2(a)(iii) condition precedent, chose not to terminate and accordingly allow Transactions to run to term without having to make any further payments or deliveries to the Defaulting Party, or
- 2) Danish insolvency law would override the provisions of the ISDA Master Agreement and allow the liquidator of the Danish insolvency estate to access the values represented by the Transactions under the ISDA Master Agreement, thus, in effect, overriding both the termination and close-out provisions of the ISDA Master Agreement as well as the Section 2(a)(iii) condition precedent.

We believe, on the basis of the below analysis, that the answer to this question is not clear, but that, on balance, it is more likely than not that the result described in 2) above would be the result reached by the Danish courts.

3 **The Danish netting act: the "notice provision"**

The issues under investigation are regulated by the Danish Securities Trading Act, Chapter 18a⁵ (in the following the "**netting act**"), which contains the provisions relating to close-out netting and implements, *inter alia*, the EU Collateral Directive⁶.

In order to understand the present provisions of the netting act discussed in this article, some knowledge of the history of the act is needed:

Until a December 2003 amendment to the netting act, the ISDA netting opinion for Denmark stated that for close-out netting to be enforceable against an insolvent Danish counterparty, Automatic Early Termination must apply to the Danish counterparty.

This conclusion was based on a lack of express recognition in the then applicable act of the right to terminate against an insolvent Danish counterparty by the giving of notice of a Non-defaulting Party. The concern was that giving the Non-defaulting Party the right to unilaterally determine the time of termination would be construed as conferring a discretionary right on the Non-defaulting Party. The preparatory works to the act specifically stated that discretionary rights could not be allowed.

Automatic Early Termination is generally considered problematic as Transactions may automatically be terminated without the parties being aware of it, and because it precludes flexibility e.g. in the form of waiver of rights by the Non-defaulting Party and negotiated solutions.

The 2003 amendment to the previous netting act included a new provision providing that two parties may, with legal effect towards third parties, agree in a netting agreement that close-out netting shall only take place once the Non-defaulting Party has given notice thereof to the Defaulting Party⁷. The provision included by the amendment is in the following referred to as the "notice provision".

⁵ Act No. 479 of 01.06.02006

⁶ Directive 2002/47 EC

The purpose of the notice provision was to recognize termination by notice of the Non-defaulting Party and thereby to address the above-mentioned concerns relating to the necessity of applying Automatic Early Termination. The provision stipulates that the parties and any insolvency estate will, following the insolvency of one of the parties, be bound by an agreement whereby termination and close-out-netting only takes place if the Non-defaulting Party gives notice thereof.

The effect of the insertion of the notice provision has been⁸ that, it is no longer necessary to make Automatic Early Termination applicable to Danish counterparties in master agreements entered into after 1st January 2004.⁹

Thus, from 1 January 2004, it is likely that any ISDA Master Agreements entered into with Danish counterparties will not provide for Automatic Early Termination and, therefore, potentially a Danish insolvency liquidator could be faced with a counterparty, which, like TXU, would rely on Section 2(a)(iii) to withhold payments and would, like TXU, not designate an Early Termination Date thus, potentially, preventing the insolvency liquidator from gaining access to contracts, which are (at least if Section 2(a)(iii) were disregarded) valuable to the insolvency estate and its creditors.

4 The netting act: the "remedial provision"

Denmark is traditionally a pro-insolvency estate jurisdiction and Danish law has traditionally favoured the rights of unsecured creditors. This explains the original position where close-out netting based on discretionary notice by the Non-defaulting Party was not recognized.

The notice provision, however, opens up for the possibility that the Non-defaulting Party would await the most opportune time for it to terminate and

⁷ Cf. Section 58h, second sentence of the netting act.

⁸ This is reflected in the most recent ISDA netting opinion for Denmark.

⁹ In that connection it may be worth bearing in mind that in order for an ISDA Master Agreement to fall within the scope of the new legislation, the ISDA Master Agreement must be entered into on or after 1 January 2004. Where parties wish to have their agreements fall within the scope of the new legislation, it would therefore, in our opinion, be necessary to amend and restate the existing master agreement. Note in that connection, that the question of whether an ISDA Master Agreement will have been entered into after the relevant date is a question to be determined under English or New York law as the law applicable to the contract, whereas the satisfaction of the test is ultimately to be determined under Danish law, but presumably with a reference to the law of the contract.

close out to the detriment of a Danish insolvency estate and, by implication, the other unsecured creditors of the estate¹⁰.

Possibly to remedy this, in traditional Danish terms, unfortunate, possibility, a provision was included in the netting act¹¹, providing that where the Defaulting Party to a close-out netting agreement, such as the ISDA Master Agreement, becomes subject to insolvency proceedings, the Defaulting Party (i.e. here the insolvent party) may demand that close-out netting is carried out in a manner which ensures that the parties are placed in the same position as if close-out netting had taken place without undue delay after the time when the Non-defaulting Party became aware, or ought to have become aware, of the insolvency proceedings in question.¹²

We shall refer to this provision, which seeks to remedy what is considered the unfortunate side effects of the notice provision, as the "remedial provision".

5 Analysis of the effects of the remedial provision

At first glance the remedial provision seems to be stating that once the Non-defaulting Party has *actually* terminated, the termination amount must be calculated on the basis of transaction values as of the time immediately following the time when the Non-defaulting Party knew or ought to have known of the insolvency.

However, the remedial provision (the wording is set out in footnote 11), is ambiguously drafted and an equally legitimate linguistic understanding of its wording is to take it as *enabling* the Defaulting (i.e. insolvent) Party itself to terminate and carry out close-out netting notwithstanding the fact that the Non-defaulting Party had not terminated.

¹⁰ In that connection it should be noted that it is debatable whether such a scenario is likely to arise. A counterparty would be unlikely to wait for its position against an insolvent counterparty to either come into the money or increase in value as it could realistically only expect to receive a fraction of its claim by way of dividends. It may be considered more likely that a counterparty to an insolvent counterparty would seek to close out its positions as soon as possible and where relevant re-establish its positions with third parties.

¹¹ Section 58h(2), second sentence, of the netting act.

¹² In English translation, the provision reads as follows: "*In situations where the defaulting party is made subject to insolvency proceedings, said party may, however, demand that close-out netting be carried out in such a manner that the conditions applicable to the parties are the same as they would have been had close-out netting been effected without undue delay after the time when the Non-defaulting*

The relevant part of the provision is the words: "*may [...] demand that close-out netting be carried out [...]*", which could well support either of the two interpretations.

6 Analysis of the remedial provision

The preparatory works to the netting act give little guidance as to which interpretation of the remedial provision is correct, and do not explicitly address the above mentioned ambiguity. However, it is clear that the intention of the provision has been to prevent the Non-defaulting Party from timing its termination to the detriment of the creditors of the insolvent counterparty.

Thus, while the relationship between the remedial provision and the notice provision points towards the less far-reaching reading (as this is the only reading, which gives true sense to the notice provision), it would seem that the purpose of the remedial provision points towards an interpretation that it would enable the insolvent party to initiate close-out netting.

Moreover, the sparse literature available on the subject is on the whole based on the assumption that the provision is "enabling" in this sense, but does not, however, expressly consider the basis on which close-out netting would then be carried out by the insolvent party, cf. the discussion hereof further below¹³.

In the face of significant ambiguity, it is relevant to analyse whether provisions of general Danish insolvency law, outside of the scope of the netting act, may provide guidance in this matter.

party knew, or ought to have known, that the defaulting party was made subject to insolvency proceedings".

¹³ Ulrik Rammeskov Bang-Pedersen, *Slutafregning* (Thomson, 2005), p. 49 *et seq.* puts forward the view that where a party becomes subject to insolvency proceedings, the counterparty will for all practical purposes be obliged to carry out close-out netting. Bang-Petersen considers (our translation) that "*Out of concern for the creditors – i.e. to avoid that the counterparty speculates to their detriment – it must therefore be assumed, that the debtor (the insolvency estate) is entitled to be placed in a position as if close-out netting had been carried through without undue delay after the counterparty became aware of the commencement of insolvency proceedings*". He considers that this is expressly provided for in Section 58h(2), second sentence, but will also apply in similar circumstances, albeit with certain modifications.

7 Termination rights under Danish insolvency law

Under Danish insolvency law an insolvency estate may terminate ongoing and otherwise non-terminable contracts of the insolvent in certain cases.

In the case of derivatives transactions covered by the scope of the netting act, this general right is limited in that it may not serve to impair close-out netting. However, in respect of the issue under discussion this would not be the case. On the contrary, the insolvency estate would seek to force through termination and close-out netting of Transactions and the calculation of its gains and losses under the Transactions in question, as of a time immediately following the time when the Non-defaulting Party knew or ought to have known of the insolvency.

Section 61 of the Danish Bankruptcy Act¹⁴ stipulates that even where an agreement does not provide for termination rights, an insolvency estate may terminate an on-going relationship with "usual or reasonable" notice¹⁵.

However, Section 61 is subject to a general caveat in Section 53 of the Bankruptcy Act, which subjects it to other legislation and to "*the nature of the legal relationship in question*".

Accordingly, Section 61 of the Bankruptcy Act may only be applied to terminate an otherwise un-terminable agreement if the remedial provision does not itself enable the Defaulting (insolvent) Party to force a close-out, and even then only if this is not precluded by "*the nature of the legal relationship in question*". For example, the "financial nature" of a relationship may serve to limit the scope of the termination right under Section 61 of the Bankruptcy Act.

Thus, in a 1981 decision¹⁶ of the Danish Western High Court it was found that the financing character of an agreement meant that the agreement could not be terminated by the insolvency estate without compensating the other party, cf. Section 61(3). This compensation constituted the party's loss due to the contract not being carried through to term.

¹⁴ Consolidated Act No. 118 of 4 February 1997 as amended.

¹⁵ The first sentence of Section 61(1) reads (in our translation)"The insolvency estate may, even if a longer termination notice, or no termination, is agreed, terminate an agreement for a continuing legal relationship with usual or reasonable notice.

¹⁶ Ufr 1981. 339

However, other than the statement made by the court that the "*financial nature*" of the agreement in that case prohibited termination by the insolvency estate unless the other party was compensated, this case sheds little light on the present investigation.

Moreover, in an Eastern High Court decision from 1983¹⁷ the court overturned the decision of the lower court pursuant to which a finance lease could not be terminated under Section 61(1) due to its financial nature. The Eastern High Court in overturning this decision stated simply that termination pursuant to Section 61 could take place (with compensation pursuant to Section 61(3)) due to the "*nature of the legal relationships*"¹⁸.

Thus, while the result was that termination pursuant to section 61 could take place, with no reasoning to support this statement, the judgment is open to interpretation: It may be read as supporting a view that financial contracts fall *within* the scope of Section 61 or it may be read as upholding the position that financial relationships should not be subject to Section 61 termination, but that finance leasing is not a true "financial relationship" and should be treated on par with operating leasing arrangements, which – it has never been disputed – may be terminated pursuant to Section 61.

While the judgment gives no guidance in this respect, in our opinion it is – based also on the 1981 decision – most likely that the latter interpretation is correct¹⁹. If this is correct, the 1983 judgment should be read as merely confirming that any leasing contract is covered by the provision, but does not impinge on the view that (true) financial contracts are not subject to the termination right contained in Section 61.

Thus, while the exact scope of the "nature of the relationship" exception in Section 53 of the Bankruptcy Act remains unclear, what is clear is that Section 61 was not drafted with financial contracts in mind and that it would be applied with caution to agreements such as Transactions under the ISDA Master Agreement.

¹⁷ Ufr 1983.813 Ø

¹⁸ In Danish "Under hensyn til retsforholdenes karakter"

¹⁹ See also in support of both finance and operating leasing arrangements being subject to Section 61 of the Danish Bankruptcy Act, Klaus Søgård in Ufr, 1984B.79

However, if the foreseeable result of applying the "nature of the relationship"-exception in Section 53 of the Bankruptcy Act (and thus excluding application of Section 61) is to give the Non-defaulting Party the option of not terminating Transactions and continuing to demand performance from the Defaulting Party in respect of the Transactions while itself withholding payments and deliveries to the Defaulting Party²⁰ (potentially indefinitely), this might be seen as an unjust enrichment of the Non-defaulting Party and as upholding a contractual provision the sole aim of which is to put certain creditors ahead of others - something which Danish law has traditionally looked upon with no great enthusiasm.

It may, on the other hand, be argued that it would be contrary to the principle of freedom of contract if a Danish insolvency estate could force through termination and close-out against the interests of the Non-defaulting Party. The principle of freedom of contract is another basic principle of Danish law, which it would normally take express legal basis to overrule, and although insolvency law is exactly an area where rules overriding the principle of freedom of contract may be found, the question is whether there is sufficient legal basis in the insolvency related provisions of the netting act to override the combined provisions of Section 2(a)(iii) and 6(a) of the ISDA Master Agreement.

If the insolvent Danish insolvent party were able to terminate, this would certainly be a result contrary to (and overriding of) the contractual rights of the parties to an ISDA Master Agreement and Transactions thereunder²¹, and it could strongly be argued that parties entering into ISDA Master Agreements should be entitled to rely on the provisions of the agreement, which (Section 6(a)) only allow the Non-defaulting Party to trigger termination (where Automatic Early Termination has not been applied) and, moreover, give such party the right to withhold payments and deliveries (Section 2(a)(iii)).

However, the policy interest in protecting creditors of an insolvency estate from being barred from access to valuable assets, or what were valuable assets at least immediately prior to the insolvency proceedings, point in the other direction.

²⁰ Relying on the condition precedent in Section 2(a)(iii) of the ISDA Master Agreement.

²¹ At least as that complex of agreements was interpreted in *Enron vs. TXU*.

While it is doubtful that Section 61 of the Bankruptcy Act in itself provides the necessary tool for the insolvent party to close out, considering the ambiguous drafting of the relevant provisions of the netting act; the likely intention behind the remedial provision; the more general intentions underlying Danish insolvency law (as expressed inter alia in Section 61 of the Bankruptcy Act) and the bias under Danish law generally towards protecting unsecured creditors of an insolvent party – in our view, it is likely that Danish courts would interpret the remedial provision in favour of the insolvency estate to allow it to close-out Transactions under the ISDA Master Agreement and to access the value represented by the underlying Transactions.

8 Effects of the "enabling" interpretation of the remedial provision

However, even if the remedial provision was found to allow a Defaulting (insolvent) Party to terminate Transactions under an ISDA Master Agreement and force close-out netting at values as of, roughly, the time of insolvency proceedings, it would not, at least not directly, have available to it the provisions of Section 6(e) of the ISDA Master Agreement relating to early termination and close-out netting.

These provisions expressly provide remedies for the Non-defaulting Party only.

The question is, therefore, whether, if the Danish courts would reach the "enabling" result, principles of general insolvency law could provide the necessary framework for such general right of close-out.

In that connection, a central question is whether the Transactions would have any value to the estate, given the operation of the condition precedent in Section 2(a)(iii), which establishes that the obligations of the Non-defaulting Party are "flawed assets", the existence and therefore value of which is conditional upon no default having occurred in respect of the Defaulting Party.

It is possible that, despite the strong preference for allowing the insolvency estate to access the value of its Transactions, Danish law would, in the absence of clear legislative provisions to the contrary, defer to English/New York law being the law governing the ISDA Master Agreement, to find that the Transactions had no value to the insolvent party.

However, in our opinion, Danish courts would more likely be persuaded by the argument that an insolvency estate - were it able to unilaterally terminate transactions under the ISDA Master Agreement, would not directly be able to use the close-out mechanisms and calculations set out in the agreement itself, but would have access to the generally applicable principles guiding its calculations of the value of its contracts and positions²².

Moreover, having come thus far in effectively re-writing the contractual arrangement between the parties, it is not unlikely that a Danish court would go even further and interpret the right to require "close-out netting" as a right for the insolvency estate to avail itself of the principles for close-out netting in Section 6(e) of the ISDA Master Agreement.

9 Conclusion

In conclusion, the notice provision and the remedial provision in conjunction seem to raise more questions than they provide answers.

While the intention behind the remedial provision is fairly clear: namely to ensure that a party to an ISDA Master Agreement with an insolvent Danish counterparty does not "time" its termination of outstanding Transactions to its own benefit and to the detriment to other creditors, it seems the legislator had not considered the possibility that the counterparty could abstain from terminating indefinitely, leaving the practical application of the provision uncertain.

Whether or not the remedial provision will be interpreted to effectively override the carefully drafted provisions of the ISDA Master Agreement to achieve its intended result is both a question of the application of the remedial provision itself and of the interrelationship between on the one hand Danish insolvency law and on the other the law governing the contract.

Ultimately, the question for a Danish court is whether the intention behind and wording of the remedial provision coupled with general principles of Danish insolvency law is sufficient to:

- (i) despite the wording in Section 6(a) of the ISDA Master Agreement, which only affords the Non-defaulting Party termination rights, allow the Defaulting Party to terminate; and, if so,
- (ii) to disregard the flawed asset provision of Section 2(a)(iii) of the ISDA Master Agreement; and
- (iii) provide the necessary framework to allow the Danish insolvency estate to access the value of its Transactions under the ISDA Master Agreement either by analogous application of the Section 6(e) mechanisms or on the basis of general principles,

in a situation where an insolvent Danish party is in the-money and its counterparty elects not to terminate and invokes its right to withhold payments and deliveries pursuant to the Section 2(a)(iii) condition precedent.

These are fairly substantial tasks for a provision as brief and lacking in detail as the remedial provision combined with basic principles of Danish insolvency law. Particularly, as this application of the remedial provision is directly contrary to the notice provision. However, these are the necessary tasks if the presumed intention behind the provision is to be fulfilled.

In our opinion, regardless of the finer analysis of both the netting act and provisions of the ISDA Master Agreement, Danish courts would for the reasons set out above be strongly inclined towards the "enabling" interpretation of the remedial provision, which is, therefore, in our opinion, the most likely result, were a case along the lines of TXU vs. Enron to appear before a Danish court.

However, as is apparent from the above, a significant element of legal uncertainty remains.

In our view, the resolution of this uncertainty merits specific legislative attention. Neither Danish participants in the derivatives markets nor their foreign counterparties are well served by the lack of certainty as to whether certain termination provisions of the ISDA Master Agreement are in fact enforceable.

As mentioned above, while we doubt that when drafting the remedial provision the Danish legislator was aware of the combined effect of Sections 2(a)(iii) and

²² Cf. as to the contents of such general regulation of close-out netting *Slutafregning*, p. 58 *et seq.*

6(a) of the ISDA Master Agreement, TXU vs. Enron provides a clear illustration thereof, and the question which therefore needs to be on the political level is: *"Should an insolvency official of a Danish party to the ISDA Master Agreement (and other similar agreements) be allowed to terminate and carry out close-out netting against the wishes of the Non-defaulting Party?"*

If the answer to this question is yes, then this should be set out clearly in the netting act²³, just as the method for determining the applicable close-out amount should be stipulated.

If, on the other hand, the Danish legislator wishes to respect the contractual freedom of the parties, and wishes that Danish courts faced with similar questions reach the same result as the Australian court in TXU vs. Enron, it is, as shown above, necessary to amend the remedial provision to clarify that it shall find application as a regulating measure *if, and only if*, the Defaulting Party chooses to exercise its termination rights.

²³ In our opinion the correct place for further legislation is in the netting act, not in the Bankruptcy Act, as in the case with the remainder of the provisions of the netting act, which disapply certain Bankruptcy Act provisions in the context of financial markets dealings.