

WELCOME TO THE SUMMER 2011 EDITION OF FINANCE FOCUS, THE REGULAR UPDATE FROM THOMAS COOPER'S FINANCE GROUP, IN WHICH YOU CAN REVIEW THE LATEST LEGAL DEVELOPMENTS IN YOUR AREA OF FINANCE AND KEEP UP TO DATE WITH THOMAS COOPER NEWS AND FORTHCOMING EVENTS.

Further Consideration of Closeout Netting Provisions under the ISDA Master Agreement (Pioneer Freight Futures Co Ltd v. Cosco Bulk Carrier Co Ltd)

Thomas Cooper acted for the successful party in the most recent English Commercial Court case interpreting the 1992 ISDA Master Agreement (the "Master Agreement"). Although the case arose in the Forward Freight Swap Agreements ("FFAs") context, it has broader implications for all derivative contracts governed by Master Agreements.

The Financial Crisis has had a marked impact on shipping markets, though relatively few insolvencies have occurred, at least so far. One particular market, however, has been profoundly affected and that is the freight futures market. FFAs are over-the-counter cash settled contracts for differences pegged to forward freight rates (various notional charter routes) as quoted on the Baltic Freight Futures Exchange Index ("Biffex") and settled monthly. Prior to the financial crisis, FFAs were predominantly contracted directly between counterparts without a clearing house mechanism to guarantee payments. When the crisis struck, and the Biffex lost 90% of its value, relatively few market participants defaulted on payment obligations and subsequently became insolvent. One of the major participants to default and subsequently go into liquidation was Pioneer Freight Futures Limited. Its default has spawned a number of cases that have recently come before the English courts. The Pioneer case examines which transactions fall within the closeout netting provisions triggered by insolvency (s. 6 of the Master Agreement).

Facts

In late 2008 Pioneer and Cosco Bulk had 11 FFAs with future contract months remaining. Pioneer defaulted on its payment obligations (a net payment of approximately USD\$ 6.5 million) for the October 2008 contract month and did not make any payments thereafter. Cosco Bulk issued a notice of default in November 2008. Pioneer's default triggered a condition precedent relieving Cosco of being obligated to make any future payments to Pioneer while Pioneer's default was continuing (as set out in s. 2 (a)(iii) of the Master Agreement). No payments were made thereafter by either party. Pioneer entered voluntarily liquidation in mid-December 2009, more than a year after the market crash and Pioneer's initial default.

The final contract month for six of the contracts was December 2008 and for two of the contracts was March 2009. The remaining three had a final contract month of December 2009. Pioneer's liquidation triggered automatic early termination under the ISDA Master Agreement under s. 6 of the Master Agreement. This required Cosco to make a good faith calculation of its loss (or gain) in respect of "outstanding transactions" between the parties. That calculation required Cosco to assume that conditions precedent relieving it of earlier payment obligations had been fulfilled. Section 6 is at the heart of the "two way" netting provisions of the Master Agreement which are evidently intended to produce a "wash out" or unwinding of the parties' positions on a neutral basis in the event of a party's insolvency rather than in accordance with ordinary contract principles which would normally relieve a non-defaulting party of further obligations to a defaulting party.

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The Issue

The issue in the Pioneer case was which of the FFAs were to be taken into account in this “wash out” mechanism required by s. 6. Cosco’s calculation took into account the three FFAs with payment obligations remaining at the date of Pioneer’s insolvency. Cosco’s position was that these were the only FFAs “outstanding” or “in effect”. Section 6 applies to “outstanding transactions” by its terms. The close out calculation is to be made in respect of transactions “in effect” by virtue of the definition of Terminated Transactions in s. 14 of the Master Agreement.¹ Before Cosco argued that eight of the FFAs had expired before, most almost a year prior to, Pioneer’s insolvency. At the time those FFAs expired, Cosco had fully performed its obligations under them as no payment obligations on its part had arisen while the contracts were live due to Pioneer’s prior uncured default. Cosco also claimed the right to set-off (as provided for in s. 6(e) of the Master Agreement) amounts due to it from Pioneer for four of the FFAs which expired in December 2008 with significant sums due to Cosco.

In a prior recent case also arising out of the 2008 financial crisis, Lomas v. JBH Frith Rixson, Briggs J, had faced the question of whether obligations which were subject to a condition precedent under s. 2(a)(iii) of the Agreement continued forever (as argued in that case by ISDA) or whether they ceased when the contract expired due to effluxion of time. Briggs J found that the obligations ceased at the expiry of the contract. In deciding the present case, Flaux J agreed with the reasoning in Lomas but went on to make a number of important findings based on construction of the Master Agreement.

Findings of the Court

First, Flaux J found that as a matter of normal contractual analysis, where a party’s obligations were subject to a condition precedent that remains unfulfilled at the end of a contract term, no ongoing obligation remains even though the condition precedent might have been fulfilled immediately before the expiry of the contract. He also considered s. 9(c) of the Master Agreement as had Briggs J. While this section of the Agreement may be obscure, Flaux J found that the reference to obligations surviving the termination of the Agreement “without prejudice to s. 2(a)(iii)” likely meant that, if at the natural termination of a contract the condition precedent remained unfulfilled, the obligation ceased. In any case, he found that the reverse, that the inclusion of the words “without prejudice to s. 2(a)(iii)” meant that the conditions precedent were meant to survive termination did not make sense as the reference to s. 2(a)(iii) would be unnecessary.

Pioneer argued that the permanent destruction of a payment obligation was a draconian result, but Flaux J found that this was the way normal contractual principles operate and it was not surprising where there was an unfulfilled condition precedent. Flaux J also considered the position where there is a physical delivery obligation under the Master Agreement rather than a payment obligation. He found that it did not make sense that physical delivery obligations would continue after expiry of the contract due to effluxion of time as the value of the item delivered could well change.

Flaux J also agreed with Briggs J’s reasoning that termination after a contract had expired due to effluxion of time could in no way be “early termination”. He found that the position argued for by Pioneer was in fact tantamount to saying that the Agreement provided for “late termination”.

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¹ Although the definition of Terminated Transactions comes into play directly under the Market Quotation method for making the closeout calculation under s. 6, the courts have held previously that the calculations under “Market Quotation” (where quotes are obtained for replacement transactions from the market) and “Loss” as used in FFA contracts are intended to achieve roughly the same result.

Pioneer argued that s. 1(c) of the Master Agreement which refers to the Agreement and each transaction and confirmation being a “single agreement” (the “single agreement” point) was intended to have the effect of bringing in all transactions under the Master Agreement including those where contract months had expired. However, Flaux J found that this provision was meant to facilitate netting of payments across transactions under a single Master Agreement and to ensure that a default in respect of one transaction was a default in respect of all outstanding transactions. It did not have the effect contended for by Pioneer. Flaux J stated that it is in fact the individual FFAs or transactions which are the contract and the Master Agreement is an umbrella agreement incorporated into the individual FFAs.

Flaux J also made what is perhaps a straightforward point, that Pioneer’s arguments that contractual obligations that survived the natural termination of a contract term remained “outstanding” or “in effect”, were a distortion of the natural language used in the Agreement. Also, by specifying transactions to be terminated as those “in effect” meant that there were others that were no longer in effect. A similar point is made as to whether such a termination could be “early” (as also found by Briggs J).

Pioneer further argued that the definition of “Loss” which referred to calculations under “this agreement” meant that those FFAs where the contract months had expired should also be included. However, Flaux J found that this did not assist Pioneer because the transactions considered under “this agreement” were only those “in effect”. Flaux J also found support for this construction in the words used in the second sentence of the definition of “Loss” which refer to payments “required to have been made...and not made”. If the contract had expired without the condition payment having been fulfilled then there was no requirement to make payment. A similar point can be made about the language used in the definition of “Unpaid Amounts”.

Flaux J also found that there was nothing inconsistent in this analysis with the reasoning of Gloster J in the case of Pioneer Freight Futures Co Ltd v. TMT Asia Limited, another of the recent Pioneer litigation FFA cases. He found that it was not part of the commercial purpose of the Agreement to have obligations exist “in limbo” after expiry of the contractual term and then spring to life again in the future should Automatic Early Termination occur. He notes that Gloster J was specifically concerned with transactions that were “open” and that she found she did not need to decide the point made by Briggs J that suspended obligations did not survive the natural termination of the contract.

Pioneer also argued that the netting provisions of s. 2(c) continued to apply despite Pioneer’s default with the result that the amounts that Pioneer argued would have been due to it from Cosco had to be brought into account in any case. This was contrary to Flaux J’s findings in Britannia Bulk Plc v. Pioneer Navigation Limited where he had considered the meaning of s. 2 (c) and found that amounts which had not become payable due to the non-fulfilment of a condition precedent did not attract netting as they were never “payable”. In this regard, Pioneer relied on “intense” criticism of Flaux J judgment in Britannia Bulk in the latest edition of the American text, Henderson on Derivatives. Flaux J reconsidered his findings on this point in view of this criticism but found that s. 2 (c) by its own terms requires amounts that are to be netted to be “payable” and that the language of that section and the use of the word “payable” in the definition of “Unpaid Amounts” meant that payable was intended to mean an immediately enforceable obligation to pay.

Flaux J also commented on his earlier finding in Marine Trade v. Pioneer Freight Futures Co Ltd that the payment obligation was a “one time” obligation, meaning that, if at the time the obligation arose there was a condition precedent in effect, the obligation was extinguished. He noted the findings of Briggs J and Gloster J to the contrary and that the obligation remained suspended (in Lomas until the expiry of the contract due to effluxion of time) but found that he did not need to revisit the point as it did not arise in this case. As those decisions were under appeal he thought it desirable not to express a concluded view.

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Flaux J has given leave to appeal. The Lomas decision is also under appeal and therefore the issues raised in these cases will be considered further by the Court of Appeal in due course.

Government consults on amending Money Laundering Regulations 2007

On 7 June 2011, HM Treasury published its [response](#) to its review of the Money Laundering Regulations 2007 (*SI 2007/2157*), together with an [impact assessment](#).

HM Treasury launched its review of the Regulations in 2009. Although the review found that the Regulations and their implementation are broadly effective and proportionate, the response sets out HM Treasury's proposals for improving the Regulations further (by strengthening the risk-based approach). The proposals are intended to give businesses greater confidence to focus compliance on their highest risk areas, and to discourage a "tick-box" approach taken by some businesses. The proposals include:

- Removing some or all of the existing criminal penalties under the Regulations. Removing the current distinction between Parts 1 and 2 of Schedule 3 to the Regulations in relation to professional bodies that may be relied on for customer due diligence (CDD) checks.
- Allowing OFT supervised retail lenders (CCFIs) who purchase debt from other CCFIs to rely on the CDD previously performed by the seller.
- Introducing a general exclusion (for example, for businesses with below EUR 15,000 VAT exclusive turnover per annum), or reducing the requirements placed on such businesses.

Comments can be made on the proposals, and the impact assessment, until 30 August 2011. Subject to final decisions, HM Treasury anticipates that any adopted legislative changes will come into effect in 2012.

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FSA and Bank of England publish paper on the Prudential Regulation Authority's approach to insurer supervision

On 20 June 2011, the FSA and the Bank of England ("BoE") published a [joint paper](#) on the approach the new Prudential Regulation Authority ("PRA") will take to the supervision of insurers.

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The PRA's regulation of insurers will seek to deliver two aims: (i) to secure an appropriate degree of policyholder protection; and (ii) to minimise the adverse impact that the failure of an insurer could have on the stability of the financial system.

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As prudential regulator, the PRA will have sole responsibility for matters relating to the interests of policyholders which could have an effect on the financial position of a firm. Effective delivery of this responsibility will require co-ordination with the new Financial Conduct Authority ("FCA"). The paper states that the co-ordination arrangements will take particular account of the nature of liabilities arising where insurers have written with-profits policies.

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Bribery Act 2010: in force on 1 July 2011

The Bribery Act 2010 came into force on 1 July 2011. This Act and the Guidance issued by the Ministry of Justice (*see article in Spring 2011 Finance Focus*) significantly strengthens the UK's anti-corruption laws.

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After the risk of “tipping off” has passed, do you have to justify to a customer why you suspected him/her of being a money launderer?

In January 2009, HSBC Private Bank (UK) Ltd (HSBC) defeated a claim brought by one of its customers who sought damages for breaches of duty and failure to follow his instructions to process transactions whilst requests for consent under the Proceeds of Crime Act 2002 (POCA) were pending with the Serious Organised Crime Agency (SOCA). On 4 February this year, the Court of Appeal allowed in part the customer’s appeal against the 2009 decision.

This opens the door to customers obtaining disclosure of a bank’s internal documents related to money laundering disclosures (once any risk of “tipping off” has passed), and may require them to justify to their customers the basis of their suspicions which led to any report to SOCA.

The case is likely to have an impact on all those who make money laundering suspicious activity reports (SARs), including banks, financial firms and others in the regulated sector. Procedures should be reviewed to ensure basis on which SARs reports are made are sound and documented.

FSA consults on draft financial crime guide

On 22 June 2011, the FSA published a [consultation paper](#) on its proposal for a new regulatory guide on financial crime (CP11/12).

Appendix 1 to CP11/12 contains a draft version of the guide, the aim of which is to provide guidance to firms on the measures they can take to reduce their financial crime risk. There are no rules in the guide and no new requirements are imposed on firms through it. The FSA makes clear in CP11/12 that the guide is not intended to compete or conflict with existing industry guidance like the guidance for the financial sector published by the Joint Money Laundering Steering Group (JMLSG).

- **Part 1** of the guide provides guidance (in the form of self-assessment questions and examples of good and poor practice on financial crime systems and controls), both generally and in relation to specific risks such as money laundering, fraud and bribery and corruption. Case studies are also included, together with sources of further information for firms.
- **Part 2** of the guide provides summaries of and links to FSA thematic reviews of various financial crime risks. It also sets out consolidated examples of good and poor practice which were included with the findings of these thematic reviews.

As with all FSA guidance, the guidance in the guide is non-binding, so firms will not be obliged to comply with it. However, the FSA will expect firms to be aware of the guidance in the guide and, where appropriate, consider how to make use of it to develop and implement more effective financial crime policies and controls. It suggests that firms review the questions and good and poor practice examples to assess and improve their existing approaches to meeting their legal and regulatory obligations in this area.

The guide covers a wide range of financial crime risk, but it is not intended to be comprehensive. It focuses principally on those areas where the FSA has conducted thematic work and areas in which firms are less likely to take unprompted preventative or remedial action. The FSA intends to keep the guide under review and will expand and update it to include reference to new risks which have been identified and also material from future thematic reviews.

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Responses to CP11/12 can be made until 21 September 2011. The FSA intends to publish a policy statement, with feedback on CP11/12 and a final version of the guide, in the fourth quarter of 2011.

Council of Mortgage Lenders (CML) is developing new instructions for "separate representation"

The Council of Mortgage Lenders (CML) is developing a set of standard instructions for a conveyancer who represents the lender, but not the borrower, in a residential conveyancing transaction.

The instructions, which consist of a draft set of instructions and an example template letter, are currently out for consultation with stakeholders, with a view to them being finalised by the end of 2011.

The intention is that the new instructions will be added to the England and Wales version of the CML Lender's Handbook.

New interbank secured lending rate ("RONIA") launched

On 6 June 2011, the Wholesale Market Brokers' Association ("WMBA") launched a new interbank lending rate for secured sterling loans, called the Repurchase Overnight Index Average (RONIA).

RONIA is the weighted average rate of all sterling overnight secured lending transactions (transactions where collateral is provided as security). It is based on "secured overnight swaps" which are repo transactions and, as such, it reflects the actual rate banks charge each other, rather than a notional rate quoted by banks, such as LIBOR.

LMA guidelines on transparency and use of information

On 6 June 2011, the Loan Market Association ("LMA") published guidelines on best practice for transparency and the use of information in the secondary loan market.

The guidelines identify participants in the loan market with three levels of information and give examples of each level. They also set out recommendations for best practice for how that information should be used and what disclosure should be made.

Statutory Demand valid despite lender's security over principal's assets

In *White v Davenham Trust Ltd [2011] EWCA Civ 747*, the Court of Appeal considered whether, under rule 6.4(d) of the Insolvency Rules 1986 (*SI 1986/1925*), to set aside a statutory demand against an individual who had guaranteed the liabilities of his company to a lender. The case turned on whether the lender's security over the assets of the principal debtor made it unjust to pursue the guarantor for the outstanding debt.

The Court of Appeal has held that a creditor's statutory demand against a surety was valid, even though the creditor held security over the assets of the principal debtor because the liability under the guarantee was undisputable and unaffected by the creditor's security over the principal's assets.

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Thomas Cooper Finance News

Global Trade Review 2011. Thomas Cooper was ranked 5th in the [Global Trade Review's 2011 Best Law Firms in Trade Finance](#) review (up from 8th last year). We would like to thank our clients for their continuing support.

GTR Roundtable 2011. Grant Eldred recently participated in the [GTR Legal Roundtable](#) with other top trade finance lawyers in London to debate current issues affecting the market including sanctions, Basel III and security issues generally.

Feedback. Thank you for your feedback on the previous edition of Finance Focus. Please forward Finance Focus to your colleagues or friends who may be interested in the content.

If you have any comments, requests for topics to be covered in the next edition please contact: financegroup@thomascooperlaw.com or your usual member of the Finance team.

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