Feature

KEY POINTS

- A solvent party may want to terminate and recover damages but will need to provide evidence that the insolvent party's actions amount to a repudiatory breach.
- Simultaneous breach may have unfortunate practical consequences when parties come to seek remedies – whereas silence and inaction can imply mutual rescission.
- The solvent party should consider certain action points depending on whether it wishes the swap to be performed or for the parties to be restored to their original positions.

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To swap or not to swap? Considerations in the face of counterparty insolvency

This article considers what happens when, in the absence of ISDA or other governing legal terms, a counterparty to a swap becomes insolvent before the final exchange date (at which the legs of the swap are due to be performed simultaneously).

A swap involving an initial exchange of value (such as a cross currency swap) is a form of executory contract. This is a contract with terms that are set to be fulfilled by both parties at a later date before it is deemed fully executed. The unique characteristics of such swap contracts, when performance is simultaneous, present distinct problems if one party becomes insolvent between the initial and final exchange dates and there has been no prior agreement as to the parties' rights and obligations in that scenario.

In the ordinary course, market standard terms, such as those provided by the International Swaps and Derivatives Association (ISDA), are incorporated into the swap contract and would address this issue. However, problems may occur if: (i) the parties do not explicitly agree to adopt such terms prior to one party becoming insolvent; (ii) necessary formalities are not observed; or (iii) courts are unable to imply that the swap was conducted on ISDA or other governing legal terms. Assuming English law governs the swap, it falls to the common law to intervene.

This article proceeds to examine the common law treatment of such contracts. Courts have yet to address the issue directly. It is, therefore, necessary to examine jurisprudence concerning other types of executory contracts for guidance.

INSOLVENCY AND BREACH OF CONTRACT

The very nature of an executory contract makes it difficult to establish breach in certain circumstances. This is because, if neither party performs their obligations when simultaneous performance is due, breach by both parties is likely to have occurred at the same time. This situation may arise if, for example, due to one party's insolvency, neither party performs on the final exchange date. A dilemma then arises as to how to attribute fault so that the innocent party may choose to terminate and claim damages.

There are three plausible analyses: (i) the insolvent party alone is in breach of contract as the solvent party has a right not to perform until the insolvent party performs; (ii) the parties breach the agreement simultaneously; or (iii) the agreement is rescinded by implied mutual agreement on or shortly after the final exchange date.

TERMINATION FOR BREACH OF CONTRACT

Right to terminate for counterparty insolvency

Absent performance, a partially performed swap, where both parties are obliged to reverse the swap on the final exchange date, would remain active until parties either fully perform the swap through reversal or bring the contract to an end. It is likely that a solvent party may want to terminate and recover damages in order to claim precipitating loss. Central to whether a solvent party may do so is to determine whether the insolvent party's actions amount to a repudiatory breach. Absent an express contractual provision, however, there is no common law right to terminate a contract on the sole basis that the counterparty has declared itself insolvent; the rationale being that the liquidator may still wish to enforce the contract and must be given the opportunity to do so. The solvent party may not, therefore, terminate purely on the basis of counterparty insolvency.

To invoke a common law right to terminate, a declaration of insolvency must occur in such circumstances as to amount to a repudiatory breach. The solvent party must provide evidence (in addition to the mere fact of insolvency) to suggest that the insolvent party put itself in such a position as to incapacitate itself from performance at the intended final exchange date. A failure to set aside assets to effect the swap is one such example. Only then may the solvent party infer anticipatory breach, legitimately terminate the swap and claim damages.

Simultaneous breach

If the solvent party cannot show any additional factor to elevate the counterparty's insolvency to a repudiatory breach, the doctrine of simultaneous breach may provide a mechanism for termination.

In this scenario, both parties would arguably have simultaneously failed to perform, and thus breached their obligations, on the final exchange date. If this is accepted, the question then naturally follows as to which party or parties may validly terminate a contract for simultaneous breach. There is a view that either party should be entitled to accept the breach and terminate (but not enforce) where both parties are guilty of breaches justifying termination, as 'no good purpose is served by holding parties to a contract after each has committed a breach justifying its termination.'[1]

This may, however, have unfortunate practical consequences when parties come to seek remedies. If both parties are in breach simultaneously, they are equally at fault. Attributing fault is, however, 'the essential feature of damages'.[2] If neither party can enforce the agreement against the other, the advantage of declaring a breach in order to claim damages is rendered redundant. Framing this problem within the doctrine of breach may, therefore, be unworkable in practice. In such situations, the doctrine of rescission may provide a more logical framework.

RESCISSION

Rescission by abandonment is distinct from

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repudiation for breach. Breach occurs by one party as against the other. Mutual agreement, express or implied, is required to rescind a wholly executory contract under which neither party has performed its obligations in full.

> 'Rescission must be by both parties; either both must have intended to rescind, or one must have so acted as to justify the other in thinking that he intended to rescind.'[3]

Where both parties are obliged to perform on the final exchange date, failure by both parties to do so may therefore amount to implied mutual rescission. In the absence of case law in the context of swaps, we must revisit old case law concerning executory contracts for guidance in this situation.

Parties must take "steps"

Absent performance, parties must take some form of action to show that they intend to keep the bargain alive. In *Morgan v Bain*, between the formation of a contract for the delivery of iron and the date of performance the claimants became insolvent. No delivery was made by the defendants or claimed by the claimants. Over a month later, the claimants claimed fulfilment of the contract and offered to pay cash on delivery. In the interim, the value of iron had increased from the contract price. The defendants relied on the fact that the claimants failed to perform their part of the contract, and argued that it was at an end. It was held that inaction by the parties had led to rescission of the contract. Neither party had taken any step in relation to the contract for over a month after performance was due.

Silence and inaction can imply mutual rescission. The court held that parties needed to take "steps" to show that they intend to be held to their bargain. No such steps were taken in this case, instead, the actions of both parties suggested that they had discharged their right to performance.

Significantly, the claimants: (i) notified the defendants that they were insolvent; (ii) made no provision for performance of the contract in the statement of affairs, though the contract was mentioned at the meeting of creditors; and (iii) did not show any other indication of intending to uphold the contract. Likewise, the defendants: (i) broke with their normal course of trade by failing to deliver goods without further demand when due; (ii) did nothing after the notice of insolvency to show that they intended to stand by the contract; and (iii) informed the claimants that the contract was at an end when the claimants wrote seeking to hold the defendants to the contract.

There are, however, limits on the requirement to take steps. The common law does not expect a solvent party to part with its money or goods to an insolvent party without guarantee of return. Instead, the solvent party could and should take steps to show that it is able and willing to perform by, for example, insisting on cash upon delivery. In the context of a swap, this could extend to sending the sum due to an intermediary or receiving agent to hold, if applicable, or confirming that payment will be made to the insolvent counterparty and setting aside the funds to do so.

Remedies for rescission

If rescission is established, restitution would ordinarily apply to restore the parties to their respective positions before the transaction. It would require the solvent and insolvent parties to return the sums originally exchanged under the swap. Unlike the damages for breach, parties are not compensated for loss.

There is no clear guidance as to whether set-off would be available in this context and the position may vary depending on the law that applies to determining the availability of set off in relation to the insolvent party. A solvent party in this situation ought to consider the availability of set-off before concluding that an argument that the swap had been rescinded was one worth pursuing.

ACTION POINTS

In the unlikely event that a party to a swap without detailed terms relating to the insolvency of one party should find that its counterparty has declared insolvency between the initial exchange date and the final exchange date, the first issue it should consider is whether it would be in a better position if: (i) the swap were performed (or it obtained damages on the basis that the swap ought to have been performed); or (ii) the parties were restored to their original positions by way of restitution after taking into account the availability of set-off against the insolvent party.

If the solvent party is in the former position, it will want to consider: (i) taking steps to show that it intends to be bound by the swap. Such steps could include putting the swap payment or delivery amount aside; (ii) contacting the insolvent party to express an intention to uphold the bargain to avoid 'breach compounded by insolent muteness'[4] should the insolvent party be deemed to have taken appropriate steps.

This is to ensure that the solvent party: (i) can terminate the swap and claim damages for loss (though, in the end, as an unsecured creditor, it may recover only a portion); and, therefore, more importantly (ii) would not be the one deemed to have repudiated the contract and potentially liable to damages should the insolvent party have taken the necessary steps.

If the solvent party is in the latter position, it will want to consider making a case for rescission.

The administrators or liquidators of an insolvent counterparty which is party to a swap should, likewise, consider the need to take "steps". If it is in the insolvent party's interest for the swap to be performed, this may require: (i) making provision for the contract by setting aside what is necessary to effect performance; (ii) communicating its intention to uphold the bargain to the solvent party; (iii) avoiding delay in taking such actions to effect the final exchange of the swap.

This should help to ensure that the liquidator: (i) has the option to enforce the contract; or (ii) is not deemed to have repudiated the contract and exposed to liability for damages, should the solvent party have taken the necessary steps. ■

1 E Peel (ed.), *Treitel on The Law of Contract*, (14th Ed, 2015) at §18–095.
2 H McGregor, *McGregor on Damages*, (19th Ed 2014), at §1–004.
3 *Morgan v Bain*, (1874) L.R. 10 C.P. 15.
4 N Andrews, *Contract Law*, (2011), at §17–02.

Further Reading:

- The troubled waters of insolvency set-off: mutuality, the *pari passu* principle and other considerations [2010] 5 JIBFL 282.
- Termination provisions of swap agreements II [2015] 2 JIBFL 83.
- LexisNexis RANDI blog: Calculating ISDA close out payments following early termination.