Feature

KEY POINTS

- To mitigate the Brexit risk, ISDA released two new Master Agreements (one in Irish Law and one in French Law).
- French Law was chosen as it is perceived to be an efficient legal system within the civil law tradition.
- French Law is entirely compatible with current OTC market practice.
- Although a French ISDA could be subject to more gap-filling than an English ISDA, this introduces flexibility particularly given that ISDA contracts are necessarily incomplete.
- Interpretation under French Law should lead to a similar result as current English judicial practice, albeit achieved via a special branch of the French law of interpretation.
- Both the English and French jurisdictions lack a set of principles, rules or interpretative techniques specifically designed for standardised terms furnished by third parties.

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The choice of French Law for the new ISDA Master Agreement: Part 1

Brexit and its consequences has led ISDA to release new contracts as the UK will lose the benefits of being inside the European Union. Two new ISDA Master Agreements can now be used: one in Irish Law and one in French Law. The aim of this article is to examine why ISDA decided to publish new Master Agreements and why French Law was selected.

THE OTC DERIVATIVES MARKET

The derivatives market has grown considerably since 1972 to almost $15bn gross in 2016. A derivative is a type of product (materialised via a financial contract) that is derived from another financial product, an index, a thing or a value (underlying asset). Derivative transactions can range from simple or plain vanilla operations (eg currency swaps) to more complex ones (eg swaption straddles). One main distinction is between derivative operations that are realised via regulated exchanges such as Multilateral Trading Facility or Organised Trading Facility (Eurolist, MATIF, MONEP etc that often concern options and forwards) and Over The Counter (OTC) derivatives where transactions are more complex, bespoke and flexible.

The OTC market is partially and increasingly regulated since the *subprime* crisis (for instance clearing obligations) but mainly rests on contract law and self-regulation via the documentation used. Globally, the most often used documentation is produced by ISDA. Founded in 1985, ISDA is an organisation comprising of various participants to the OTC market and produces the standardised documentation used by the market. The organisation also promotes and ensures the certainty of its templates by obtaining opinions from local lawyers on the validity and enforceability of the documentation.

ISDA documentation is made up of the Master Agreement and the ancillary documents such as the Credit Support Documentation (that includes many annexes for variation margin, etc).
A derivative trade will usually be materialised through a Master Agreement, a Schedule, Confirmations, Definitions booklets (eg Municipal Counterparty Definitions or Commodity Derivatives Definitions) and a Credit Support Annex. It must be noted that the Master Agreement plays a pivotal role. It is the framework agreement, ie a unique umbrella whose terms will apply to every operation signed by the parties. Derivative documentation includes provisions regarding the financial aspects of the transaction (which are in the Confirmations that incorporate Definitions, specify economic terms of each transaction etc) and provisions determining the general, legal, credit and trading relationship of the parties (in the Master Agreement).

Traditionally the ISDA Master Agreement came with a choice of law clause giving the parties the option to elect either English or New York law. Whilst New York law is often selected for American operations, English law is usually selected in the rest of the world. It is indeed extremely popular in international business contracts, especially derivatives.

IMPACT OF BREXIT IN THE OTC DERIVATIVES MARKET

Brexit has many consequences for the OTC derivatives market, the financial markets and the UK as a whole.

First, when exiting the European Union, the UK will lose all the benefits of passporting. Furthermore, by combining Arts 3(a)(iv) and 5(a)(iv) of the 2002 ISDA Master Agreement, loss of the European accreditation (passporting rights) is an event allowing the counterparty to terminate the contract early. Alternatively, loss of accreditation could be seen as an illegality for new contracts entered into after Brexit.

Second, parties to an English contract will need to modify them to make them conform to fundamental requirements of European Law if (or when) the UK becomes a Third Country to the Union. For example, parties to an English Law contract (such as an ISDA) will need to add bail-in clauses (Art 55 of the Bank Recovery and Resolution Directive) and recognition of stays (Arts 68-71 of the Bank Recovery and Resolution Directive). There are other matters to consider such as the disappearance of LIBOR which has prompted ISDA to release Benchmark Supplements and launch consultations on how to calculate fallbacks based on Risk Free Rates.

Thirdly and most importantly, the UK will lose the benefit of automatic recognition and immediate enforcement of judgments of one member state in another member state. Indeed, by exiting the European Union, the Recast Brussels I, the Lugano and the

Hague conventions (the latter only works for exclusive jurisdiction clauses and thus not the 2002 ISDA, but ISDA have released a guide with conforming model clauses: 2018 ISDA Choice of Court and Governing Law Guide) will no longer apply to the UK.

This means that parties to an English Law contract will need to rely on *exequatur procedures* (which exist and are used, namely for US judgments). *Exequatur* will necessarily be longer, pricier, and this could be devastating if your counterparty is approaching insolvency. Furthermore, such delays would be contrary to the logic of financial contracts that often rely on financial collateral because it is quick and effective (hence the Financial Collateral Directive of 2002). This would no longer be the case as the enforcement of such collateral would require an *exequatur* judgment both in the country of the insolvent party's real or incorporated seat and also in the country where the collateral is situated. *Exequatur* procedures currently take three to six months on average. However, given the breadth of use of English law in international trade, after Brexit European Union courts could quickly become overwhelmed by requests which will increase the average time such a procedure takes.

SOLUTIONS TO THE BREXIT RISK

Several solutions can be used to mitigate the Brexit risk highlighted above.

- First, use Rome I to choose the governing Law as Rome I is not exclusive to member states. This means that the UK could re-join after Brexit (the same could be done for the Lugano convention and has already been done for the Hague convention in case of a hard Brexit). Then, parties could still keep English law but elect an EU court to settle the matter as Rome I would bind that court. However, to truly tempt the parties, foreign courts would need to demonstrate serious expertise in English law. Furthermore, within the ISDA documentation the jurisdiction and choice of law clauses are meant to work together. By not combining them, you would lose the benefit of any legal opinions as none exist on the combination of law A with a choice of jurisdiction B.
- Second, parties could decide to keep English law but resolve disputes using arbitration (eg ICC or P.R.I.M.E Finance). Arbitration awards do benefit from a special recognition and enforcement mechanism (New York Convention 1958) but are limited in case of insolvency of the parties as awards are declaratory. This means that the counterparty would still need to join the general insolvency proceedings and specific proceedings for collateral in foreign jurisdictions.
- Third, market participants could restructure their contracts. Indeed, some parties are concluding *duplication agreements*, ie reproducing their English ISDA via an entity within the European Union to benefit from a European presence. Other parties are concluding *novation agreements* (on the basis of models furnished by ISDA) which aim to maintain the accreditation benefit of the host country's entity.
- Fourth, to mitigate the Brexit risk, parties could decide to adopt one of the new contracts published by ISDA. Indeed, the organisation decided to release a new common law Master Agreement and a new civil law Master Agreement. It must be emphasised that ISDA documentation is a risk-management tool that relies on the validity and enforceability of the contract. This depends heavily on the law governing the contract. For certainty and efficiency reasons, ISDA limited the choice of governing law in the Master Agreement to two laws: English and New York. Limiting the choice of law to two common law jurisdictions reduces fragmentation and basis risk. Of course, unofficial translations exist and local opinions have been provided but ISDA never proposed any other governing law until the Brexit vote (with the particular exception of Japanese law that is only used in the Japanese domestic market). Because of Brexit, ISDA decided to release two new Master Agreements that would be submitted to the law of a member state of the European Union.

DRAFTING THE FRENCH LAW ISDA MASTER AGREEMENT

The starting point for the two new Master Agreements is the 2002 model (as ISDA is still trying to encourage market participants to switch to the 2002 ISDA). In the Irish Master Agreement, only cls 13a and 13b have changed, ie the ones pertaining to the choice of law. The French contract registers slightly more differences from the English one, but still resembles the original 2002 ISDA Master Agreement in almost every aspect.

While most changes are superficial or terminological, some express major differences between English and French law. For instance, the flawed asset theory (that a cash deposit with a bank is only repayable if a previous condition is fulfilled) is unlikely to be valid and enforceable in French Law (Art 1170 of the French Civil Code). Instead of conditioning the very existence of the obligation of a party to the performance of the reciprocal obligations by the counterparty, the French Master Agreement just conditions the *performance* of said obligation. The drafting incorporates the ISDA *Metavante* amendment to s 2(a)(iii) that aimed to avoid the possibility of suspending indefinitely the performance of the contract by the non-defaulting party, as recognised in *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch). This grants the parties a contractual right that is different from the defence for non-performance (on which see Art 1219 of the French Civil Code).

Regarding the support and institutional approval for the drafting of the French Master Agreement, the legal high committee for financial markets of Paris (*Haut Comité Juridique de la Place Financière de Paris*) was very helpful as well as the working group set up by the Jones Day Paris office.

A bilingual version of the French Master Agreement was published with a clause of prevailing language in the Schedule at the parties' discretion. It must be noted that depending on your counterparty

(eg certain public entities), the use of the French language may be mandatory.

FRENCH LAW FOR THE NEW ISDA MASTER AGREEMENT

Numerous reasons explain why French Law was selected for the *civil law* ISDA. It mainly rests on the efficiency of the French legal system and its compatibility with the financial markets. It is true that The Doing Business Report initially ranked common law systems well above civil law systems in terms of efficiency. The idea still lingers that certain systems are more efficient than others, with English law often seen as one of the most attractive legal systems in the world. But this has also been greatly criticised both methodologically and epistemologically.

French Law is efficient and quite business-friendly.

- In fact, French law was actually changed to accommodate both market and ISDA needs. For example, the limitation on the compounding of interest (Art 1343-2 of the French Civil Code) was modified for financial contracts (resulting in the modified Art L. 211-40 of the French Monetary and Financial Code) so that the ISDA Master Agreement would not need to be amended. Furthermore, the Legal High Committee for Financial Markets of Paris has introduced the possibility of replicating previous ISDA agreements under French law. An Ordinance which will come into force in the event of a hard Brexit creates a safe harbour regime during the 12-month period immediately following the Ordinance coming into force. Replication is equally useful as ISDA negotiations can be costly. Other aspects were also modified (eg the domain of close-out netting was extended etc).
- French Consumer Law only applies to physical persons and not companies. Indeed, French Consumer Law does not concern business deals.
- French is very favourable to netting and other devices used by ISDA contracts.

French Law is entirely compatible with the logic and needs of the financial markets. Indeed, and unlike other continental systems, French Law is compatible with the protocol method for updating ISDA documentation. This method relies on ISDA proposing and or recording a potential change to an ISDA document (such as Stay US, EMIR or the Benchmark protocol). All counterparties to an ISDA agreement can participate:

- ISDA proposes a change (recorded in the ISDA website);
- parties to an ISDA contract agree or not on the change (partially or totally);
- all the parties to a contract agree to exactly the same changes, the contract is modified automatically.

This method for managing change saves times because it is not necessary to renegotiate and modify/amend each contract individually. This process would work under French Law as it satisfies the requirements of offer and acceptance (Art 1113 and follows the French Civil Code). Additionally, proof is not formalised in commercial matters (Art L. 110-3 of the French Commercial Code).

Finally, it is of the utmost importance that ISDA contracts are interpreted uniformly. This point merits further development on the rules surrounding contractual interpretation in English and French Law.

INTERPRETATION IN COMPARATIVE CONTRACT LAW

The meaning of a contract rests upon the common will of the parties and interpretation is the process of determining or ascertaining the meaning. Interpretation *lato sensu* (a broad interpretation) relies on numerous techniques: interpretation *stricto sensu* (a narrow or strict interpretation), implication, rectification and characterisation. When taking a holistic view, the main differences between the English and French law of interpretation are threefold: French judges have access to (and are often obliged to use) more information, implication has a greater scope and interpretation is *subjective* in French law. But this will not necessarily lead to diverging results in the interpretation of the *ISDA Master Agreement*.

INFORMATION AND INTERPRETATION

In French Law, the judge can take into account all precontractual information contrary to English law. Under English law, the *parole evidence rule* prohibits the use of acts exterior to the contract or oral evidence to interpret it. This is justified for reasons of certainty, efficiency and common sense as pre-contractual information can only establish the pre-contractual intentions or negotiating positions of the parties (*Prenn v Simmonds* [1971] 1 WLR 1381). Thus in practice parties to a French contract often insert an entire agreement clause (as can be found in the French ISDA Master Agreement) whilst English parties wishing to stray from the *parole evidence rule* will often stipulate the contract does not contain the entirety of their agreement (*Couchman v Hill* [1947] KB 554). Therefore, although the default positions are quite different, the drafting of the Master Agreement actually aligns the rules applicable to the French ISDA with those of general English contract law.

IMPLICATION AND INTERPRETATION

Implication is a process of adding implied terms to the explicit content of the contract. In English law, terms can be implied in fact or in law (*Liverpool City Council v Irwin* [1977] AC 239). Terms implied in fact depend on the particular circumstances surrounding the agreement. However, these terms must satisfy either the business efficacy test (*The Moorcock* (1889) 14 PD 64) or the reasonable spectator test (*Groveholt Ltd v Hughes* [2010] EWCA Civ 538). Terms implied in law are closer to mandatory or default characterisation for a French lawyer.

In French law the boundary between implication and interpretation is less apparent and contracts appear less complete than English ones. This is because parties to a French contract can rely on general norms (French Civil Code etc) to fill gaps, in contrast to parties to an English contract. Not only does this mean English contracts tend to be more complete but also that they are treated as such by the courts (*Marks & Spencer Plc v BNP Paribas Securities Services Trust Co*

(Jersey) Ltd [2015] UKSC 72). Nothing is, or should be, implied in commercial contracts under English Law (*Crema v Cenkos Securities plc* [2010] EWCA Civ 1444).

Theoretically, a French ISDA could be subject to more gap-filling than an English ISDA. Although criticised this is actually quite efficient as it reduces the need for lengthy drafting and transaction costs. Furthermore, implication (Art 1194 of the French Civil Code) is based on the law of *équité* or practices (*usages*). The French courts have declared that English and New York precedents would be treated as *commercial practices* for the basis of Art 1194 (this was declared in a recent conference hosted at the Paris Court of Appeal on the 14 June 2019 entitled *L'attractivité de la Place de Paris Les chambres commerciales internationales : fonctionnement et trajectoire*).

The French openness should serve to reassure the financial markets particularly as an ISDA contract is necessarily incomplete. This is quite logical as a complete contract, if possible, would not be flexible and could lead to disputes. Markets prefer to have short incomplete contracts with good faith obligations and to trust the dealers.

CHARACTERISATION AND INTERPRETATION

Both the English and French legal system control and admit (re)characterisation. For instance, English law has known cases regarding the recharacterisation of a fixed charge into a floating charge (*Lloyds and Scottish Finance Ltd v Cyril Lord Carpet Sales Limited* [1992] BCLC 609). Foreign lawyers are often wary of French judges for fear that they interfere more freely with the characterisation of a contract (this is no doubt due to Art 12 of the French Civil Procedure Code). But cases of (re)characterisation mainly concern fraud or, as also happens in English law – but perhaps less frequently in English law, contracts that are ill-named (*Re George Inglefield Ltd* [1933] Ch. 1).

A recent case illustrates how respectful French commercial courts are of party autonomy. An insolvency administrator was seeking to contest the denomination value given by the parties in a derivatives contract in order to elude the safe harbour on enforcement given to these arrangements and return to ordinary insolvency rules. The summary judge did not permit the insolvency administrator to stray from the parties' characterisation (T. com. Paris, ordonnance, 4/7/2019, n° RG 2019031042). The judge insisted on the clarity of the parties' contractual terms, freedom of contract and the sophistication of the parties. This business-friendly approach of the Parisian courts should be appreciated by the markets and those apprehensive of switching the governing law.

CURRENT INTERPRETATION OF ISDA DOCUMENTATION

As we have seen, neither the information available to the judge nor the rules surrounding implication and characterisation would disadvantage parties to a French ISDA over parties to an English ISDA. The main problem however could lie in the norms governing interpretation *stricto sensu*. In this area, English law favours an objective approach to interpretation while French law is sometimes criticised for being primarily subjective (Art 1188 of the French Civil Code). Indeed, the former is seen as more certain. But this means that English law is more interested in what the parties apparently agreed (a more *literal* approach nowadays as shown in *Arnold v Britton* [2015] 2 WLR 1593) whilst French law is concerned with the real intentions of the parties.

However, an ISDA Master Agreement is not like an ordinary contract as it is a standardised contract that is drafted by a third party and repeatedly used by market participants. It must be noted, though, that ISDA documentation can be negotiated, altered and tailored which is why any inconsistencies between the Master Agreement and a Schedule or a Confirmation are resolved in favour of the Schedule or Confirmation. Regardless, in the presence of *standardised terms that are used repeatedly*, French judges have to interpret the contract *objectively* in order to ensure harmonisation among these recurring terms. The Court of Cassation actually makes sure of this and controls the interpretation of recurring standard terms by the lower courts – although, in principle, the Court of Cassation is unable to reconsider a lower court's interpretation except if that lower court obviously violates the meaning of a clear term (Art 1192 of the French Civil Code). As this happens for many contracts where the terms are usually drafted once and then used on many occasions (such as insurance contracts), it is safe to assume that under French Law, interpretation of an ISDA Master Agreement will be *objective*.

Therefore an ISDA Master Agreement will be interpreted in a similar objective way in both legal systems. However, French law would achieve this via a special branch of the Law of interpretation whilst English Law would resort to general contractual interpretation.

THE NEED FOR SPECIFIC RULES GOVERNING THE INTERPRETATION OF AN ISDA CONTRACT

Although both English and French law require that an ISDA Master Agreement be interpreted objectively, they do not specify *exactly* how to do so. Many interpretative techniques are available and this could lead to a disparity between the courts in one legal system or between each legal system. Such divergence would be dangerous for the OTC market.

Unfortunately, most legal systems do not yet offer solid legal rules for interpreting ISDA documentation (although the recent *Re Lehman* [2016] EWHC 2417 (Ch) is a step in the right direction). Indeed, currently French law only separates negotiated terms from *imposed* terms (Art 1190 of the French Civil Code). But an important distinction must be recognised between standard terms that come from one of the parties to the contract and standard terms that were not drafted by either of the parties as is the case with the ISDA Master Agreement. Both must be interpreted *objectively*, but not necessarily in the same manner.

For the standard terms of one of the parties, the courts will need to check whether the terms were put forward by one of the parties or could have been negotiated. If they

could have been negotiated, then an objective (literal and contextual) approach would suffice. If they could not have been negotiated then, in case of ambiguity, the maxim *contra proferentem* would be applicable.

In the presence of standard terms furnished by a third-party, it seems futile to probe (objectively or subjectively) the acts of the parties as neither contributed to the drafting. Thus, the matrix of facts or the commercial context surrounding the contract is irrelevant (*AIB Group (UK) Ltd v Martin* [2002] 1 WLR 94).

What is lacking in both jurisdictions is a set of principles, rules or interpretative techniques specifically designed for standardised terms furnished by third parties. Some authors have suggested a *historical* method of interpretation (taking into account circumstances prior to the drafting of the standard forms) recognising the normative status of ISDA. Historical interpretation would ground the meaning of the drafting context. Moreover, users' guides published by ISDA would be relevant. Although sound, such a proposition neglects that market expectations as to the terms may evolve and fluctuate between the date of drafting, of publication and/or adoption of the Master Agreement by the parties and of the conclusion of various transactions etc.

In proposing new rules, the rationality of OTC trades must be understood. To grasp them an example of certain practices should be developed. Parties often mirror a trade to hedge their risks. That is to say they sometimes conclude a *mirror-swap* (with a different dealer) to hedge their *counter-swap*. What if one trade is conducted in English law and the other in French law? If the courts come to different conclusions, then the whole logic of hedging would be undone. There is both a liquidity and a basis risk. This must be qualified as in practice there already exists a certain basis risk between New York and English Master Agreements (as was shown in the *Belmont/Perpetual Trustee* cases relating to the validity of a flip-clause) and yet participants use them in hedging operations.

Therefore, what counts is certainty and clarity. The market expects a certain consistent standard of interpretation and this leads to more certainty which in turn has an impact on liquidity and risk-management. Thus, rules relating to the interpretation of ISDA documentation must satisfy the need for coherent, consistent, clear and certain results.

SUGGESTIONS REGARDING THE INTERPRETATION OF AN ISDA CONTRACT

- A literal approach is to be favoured over an overtly contextual one as neither party to an ISDA Master Agreement was involved in the drafting. However, any clauses added or modified by the parties should be interpreted in a contextual light. For instance, when parties add specific notification conditions for the exercise of an option, then the judge can reasonably interpret it as being more restrictive than the standard drafting.
- Given that an ISDA Master Agreement has to be flexible enough to adapt itself to very different operations (in contrast, eg to the Definitions booklets that are more operation-sensitive), judges should avoid adopting a restrictive/narrow meaning in the presence of ambiguity (*Anthracite Rated Investments (Jersey) Limited v Lehman Brothers Finance S.A* [2011] 2 Lloyd's Rep. 538).
- The maxim *contra proferentem* is of no relevance (on the evolution of *contra proferentem* see *Nabahar-Cookson v The Hut Group Ltd* [2016] EWCA 128) because if neither party was involved in the drafting neither party will have put the ambiguous terms forward). However behavioural norms such as good faith and reasonableness are extremely significant.
- Judges can rely on the drafting context, ISDA users' guides, market practice and interventions by ISDA.
- To summarise, the following sources are relevant:
  - market practice at the time when the parties concluded the Master Agreement or Confirmations;
  - meaning of ISDA at the time of drafting;
  - changed meaning given officially by ISDA (in a user guide or as intervener for instance);
  - as close to unanimous market interpretation (buy and sell-side) as possible;
  - previous judicial interpretations of similar provisions (*interpretative precedent*) which the French courts assimilate to a *usage/practice*.

POTENTIAL OF THE FRENCH LAW ISDA?

To conclude, French law was selected by ISDA from the other legal systems belonging to the civil law tradition because it appears compatible with the financial markets, business friendly and has been modified to suit the needs of the OTC market. Furthermore, upon analysis interpretation in French courts should lead to similar results although interpretation of ISDA contracts more generally could be improved in all legal systems.

However, the adoption of the new French Law Master Agreement rests on many considerations linked to the negotiation process of an ISDA and to the French legal system as a whole.

Depending on the parties and the operations desired, negotiating a Master Agreement can be a long process. In fact, parties sometimes begin trading via long-form Confirmations before finalising their agreement on the Master Agreement. Switching legal systems means renegotiating the Master Agreements. Thus, it could be reasoned that unless substantive law (such as a directive from the European Union) imposes the use of French or a member state's law then parties will not wish to change their documentation.

On top of the *time* they consume (and clearly parties have other pressing issues to address as highlighted above), negotiations can also be *costly*. Pricing may differ per Master Agreement even though they govern a similar operation. It can be more expensive to use different laws because the counterparties do not know the legal system, they perceive it as more risky or less certain, their enforcement costs are higher (eg they do not know local law firms and/or cannot

use a law firm that is close to them; they may have to deal in a different language or travel for enforcement proceedings etc). Given the supposed uncertainty surrounding the French Master Agreement, participants could price its use higher. In reality, a French Master Agreement may be cheaper as the cost of justice in France is comparatively low (the cost to plead, excluding counsel fees) compared to the UK or New York. Thus, adopting a French ISDA may be less expensive in the long run, although given lack of visibility on the market, use of such a contract may impact its liquidity in the short-term.

On top of the costs there is uncertainty in using a new contract regardless of how well it is drafted. Users sometimes prefer a template with a predictable implementation to an untested contract. This has been observed when ISDA introduced a new Master Agreement in 2002 as market participants were slow and reluctant to adopt it. Indeed, ISDA is still trying to encourage participants to move to the 2002 version (hence why the 1992 documentation has not been updated). Adoption depends on the attractiveness of the law and the courts – and on these points many criticisms have been formulated with regards to French law and French judges. These points will be examined and qualified in Part 2 – *Challenging the criticisms directed at French Law as the civil law choice for the new ISDA Master Agreement*. ■

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Feature

Biog box

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Further Reading:

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- Post-Brexit: the factors increasing the pressure to refer matters to EU law (2018) 3 JIBFL 135.
- LexisPSL: Banking & Finance: Practice note: European derivatives master agreements.