Linklaters

Memorandum

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To International Swaps and Derivatives Association, Inc

From Simon Firth

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Novations under English law

In connection with the publication of the 2004 ISDA Novation Definitions (the "**Novation Definitions**") you have asked me to prepare an overview of the nature of a novation under English law and the steps that need to be taken to ensure that such a novation is enforceable.

1 Meaning of "novation"

The classic definition of the meaning of the term "novation" was given by Lord Selborne LC in *Scarf v Jardine* (1882) 7 App Cas 345, 351, who considered the term to mean:

> "that there being a contract in existence, some new contract is substituted for it, either between the same parties (for that might be) or between different parties; the consideration mutually being the discharge of the old contract".

A novation usually involves one of the parties to the original contract having identical rights and obligations under the new one, except that they are enforceable against or owed to a third party instead (ie the third party, in effect, takes over the rights and obligations of one of the parties). However, the term is wide enough to encompass an arrangement under which *both* parties to the original contract are substituted, so that the new contract is between two completely different parties (see, for example, Exhibit C to the Novation Definitions).

An arrangement under which a new contract is substituted for only *some* of the rights and obligations under another contract, so that the original contract remains in existence but the rights and obligations are reduced in equal measure to those created under the new one (sometimes described as a "partial novation") strictly falls outside Lord Selborne's definition. This is the approach adopted in Exhibit B of the Novation Definitions. However, I think it is clear that this would not affect the enforceability of the arrangements. Provided that it is clear what the parties intended to achieve, the terminology they use to describe them is immaterial. It follows that there is no reason to believe that arrangements such as those described in Exhibit B of the Novation Definitions could be attacked on this ground.

It is a matter of construction whether the novation extends to any rights and obligations that were due to have been performed prior to the novation date but remain outstanding, or whether it only includes rights and obligations which fall due after the novation date. It is also a matter of construction whether a remedy for any prior breach of contract is novated or whether it remains with the original party.

A list of the names of the partners and their professional qualifications is open to inspection at One Silk Street, London EC2Y 8HQ. The partners are solicitors, registered foreign lawyers or registered European lawyers. The firm is regulated by the Law Society.

Please refer to www.linklaters.com/regulation for important information on the regulatory position of the firm.

2 Enforceability

2.1 Enforceability of the underlying transaction

For a novation to be effective, the underlying transaction probably has to be valid and binding as, in the absence of this, there would be no rights or obligations to be transferred. The agreement of the counterparties to the new contract to undertake equivalent obligations towards each other would therefore be devoid of content unless the novation transaction contemplates that these obligations will be assumed without regard to their enforceability prior to the novation.

2.2 Enforceability of the novation transaction

Since a novation involves the termination or (in the case of a partial novation) variation of one contract and the creation of another, the consent of each of the parties must be obtained. Any formalities that are required for the new contract to be effective must be observed (for example, the novation of a guarantee must be evidenced in writing containing the guarantor's name or signature). However, in the context of derivatives transactions it is rare for any formalities to be required. A novation transaction itself does not have to be in any particular form.

Unless a novation transaction is executed by deed, it must be supported by consideration.[1] Consideration must be provided both for the release by a party from its obligations under the original contract (or a reduction of those obligations) and for the acquisition by a party of any rights under the new one. Where the novation involves obligations owed by each party to the original contract, the consideration will be the mutual surrender of these obligations and the acquisition by each party to the new contract of obligations to each other.

If only one party to the original contract has any outstanding obligations, whether any consideration is provided by it for the release of those obligations will depend on the circumstances. If the novation involves it incurring obligations in favour of a third party (ie the counterparty to the new contract), the consideration will generally be its agreement to acquire those obligations as they will be acquired at the request of the original counterparty. On the other hand, if the party that is released acquires no further obligations as a result of the novation (as where its obligations are novated to a third party or the new contract is between two different entities), consideration may be absent unless the release is effected in return for a payment. Similarly, there may be no consideration for the agreement of the new counterparty to incur the obligations that are novated to it unless it receives a payment in return. The payment requirements would not, however, have to be set out in the novation agreement itself: they could be contained in a separate document that is entered into (or comes into effect) at the same time.

Where it unclear whether a party is providing consideration for the release or reduction of its obligations, or for its agreement to assume new obligations, it would be advisable for the novation transaction to be executed as a deed. This constitutes an exception to the requirement for consideration.

[1] Under the Contracts (Rights of Third Parties) Act 1999, a third party may enforce a term of a contract that is made for its benefit. However, this is unlikely to be of assistance in the context of a novation as it does not avoid the need for that contract itself to be made by deed or be supported by consideration.

A novation will be enforceable even if the transaction(s) that are to be novated are described generically: it is not necessary to specify each one expressly. A novation could, for example, extend to all interest rate swaps that are outstanding between the parties. The description must, however, be clear enough to be able to ascertain which transactions are subject to the novation arrangements.

3 Guaranteed and secured obligations

Where a transaction that is subject to a guarantee from a third party is novated, there is a risk that the guarantee will be discharged if the consent of the guarantor is not obtained. A similar risk exists where a third party has provided security in respect of the transaction. This is to be expected where the guaranteed or secured obligations are novated to another person as the obligations would then be owed by a different entity. However, the risk also exists (a) as regards any obligations which are *not* transferred (ie following a partial novation) or (b) where the guaranteed entity continues to have obligations following the novation but they are owed *to* a different entity. This is because, as a general principle, a guarantee is discharged if the underlying agreement is altered to the detriment, or possible detriment, of the guarantor unless the alteration is obviously insubstantial. A similar principle applies to security interests.

Although many guarantees and security agreements contain provisions that are intended to avoid them being affected by such an event, it cannot be assumed that the necessary language has been included or, if it has, that it is wide enough to cover this type of arrangement. There is also case law which suggests that the courts will not necessarily take an unduly strict approach: in *Bradford Old Bank Limited v Sutcliffe* [1918] 2 KB 833, the Court of Appeal held that the novation of an existing and ascertained guaranteed debt to another creditor, where there is no change to the terms of the repayment of the debt, does not discharge the guarantor. However, it is unclear whether this principle would be extended to partial novations, or to obligations which are not yet ascertained. If there is any increase in credit risk as a result of the novation, in the absence of consent or an appropriate provision in the guarantee/security agreement, it is likely that the surety would have a defence. In any event, where a new creditor is substituted under a guaranteed transaction, it will not be able to enforce the guarantee unless the benefit of the guarantee is assigned or separately novated to it.

This would not affect the enforceability of the novation itself. However, as it could affect the credit risk involved, it is an issue of which the parties to a novation transaction should be aware.