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Closing Out Derivative Contracts Following Brexit

The turmoil in financial markets after the shock Brexit vote on 23 June can be expected to lead to defaults and close outs under derivative contracts caused by, for example:

- Market movements leading to margin calls, which counterparties may be unwilling or unable to meet.
- Events of default or potential events of default occurring, for example, if relevant sovereigns, financial institutions or other entities suffer ratings downgrades in the coming weeks and months.
- Repudiation of contracts by out of the money counterparties claiming not to be bound by their terms.

The last wave of defaults following the financial crisis in 2008 have resulted in guidance being provided by the English courts on various aspects of the default and close out mechanisms under ISDA-based and similar derivative agreements. This note looks at selected lessons to bear in mind this time.

Robust Calculation of Early Termination Amounts

It is best to adhere as closely as possible to whichever close out calculation methodology is chosen in any given derivative contract. Deviation will inevitably invite challenge by the paying counterparty. The calculating party should take time to understand properly what is required by the agreement, to document the steps taken to reach a figure, and record the reasons behind key decisions made. Calculation statements like that required by section 6(d)(i) of the ISDA master agreement should also be carefully drafted. This paper trail will be scrutinised by the courts if a dispute ensues. Two recent examples from the courts in this area are worth noting:

- The parties to put and call options had elected "market quotation" as their close out calculation method. Following early termination caused by the Lehman insolvencies, the non-defaulting party did not seek price quotations (despite evidence it could have done so and would have obtained at least three quotes). Instead it calculated an amount based on retrospective valuations. Gateways in the ISDA master agreement allowed use of the loss method where a market quotation (i) could not be determined; or (ii) would not (in the reasonable belief of the non-defaulting party) produce a commercially reasonable result. But the court held neither situation had been shown to have arisen. It held that the non-defaulting party had not calculated the amount due properly, and awarded a different sum[1].
- The parties to a put option had elected the "loss" method under a 1992 ISDA master agreement. The non-defaulting party had to "reasonably determine in good faith" its total losses and costs. Following early termination triggered by the Lehman insolvencies, the non-defaulting party calculated its loss based on the price of a replacement put option entered into some eight months later, with different maturity and credit enhancement. But the court held that the determination was reasonable in the sense that it was not irrational, i.e. a figure no reasonable party could have arrived at. The court decided it had not been possible to find a replacement transaction earlier, and in any event it would have made no difference to the amount. It also decided that the differences between the replacement transaction and the original one did not significantly impact the price of the replacement option[2].

These decisions send mixed messages. An attempt at calculating under the loss method will only be struck down if it is "irrational", giving the calculating party some latitude. It is also not necessary to put the interests of the defaulting party ahead of those of the non-defaulting party. The market quotation method is less flexible than the loss method and the gateways to the loss method in market quotation method contracts are hard to get through. A cautious approach is recommended under both calculation methodologies.

Giving Proper Notice

It is always the safest strategy to comply as faithfully as possible with the contractual provisions for giving notices regarding default, early termination and close out of derivative contracts. Consider carefully what is required in terms of which legal entity to serve notice upon, at which address, by which method and at what time. Consider also what a given notice is required to contain.

In some scenarios courts have been strict on notice requirements. For example, in one case[3] a notice to extend an interest rate collar failed because notice exercising an option to extend was given by e-mail and voicemail, which did not comply with the contractual requirements.

In other areas the courts have been more lenient. In one important 2016 Court of Appeal decision[4] the non-defaulting party served a notice of the amount payable on early termination of two currency swaps governed by a 1992 ISDA master agreement. The notice did not give sufficient details of how the amount had been calculated. When challenged, a second notice was served with more detail but that did not comply with the requirement to be served "as soon as reasonably practicable following an Early Termination Date".

1 *Lehman Brothers Finance SA (in liquidation) v Sal Oppenheim jr & cir KGaA* [2014] EWHC 2627 (Comm)

2 *Fondazione Enasarco v Lehman Brothers Finance SA* [2015] EWHC 1307

3 *Greenclose Ltd v National Westminster Bank Plc* [2014] EWHC 1156 (Ch)

4 *Goldman Sachs International v Videocon Global Ltd and another* [2016] EWCA Civ 130

The court held that although the non-defaulting party had breached the notice requirements it was nonetheless entitled to payment of the amount claimed[5].

Although the non-defaulting party was spared in this case, strict compliance with the notice requirements and giving as much calculation information as possible is advisable in order to avoid challenge, delay, and wasted legal costs.

Attempts to Avoid Early Termination Payment Provisions

Recent years have also seen some creative arguments to try to avoid the normal operation of close out mechanisms. Some notable examples include the following:

- In a well-known 2012 decision the Court of Appeal held that section 2(a)(iii) of the ISDA master agreement suspended rather than extinguished payment obligations that accrued at a time when the receiving party was in default. Those payment obligations still had to be taken into account in calculating amounts payable on a subsequent termination. And once termination did arise, calculations should be on the assumed basis that the parties would meet their respective obligations under the contract, even if in fact they could not have done so[6].
- A paying party argued that it had been mis-sold the interest rate swaps in dispute, and that it could set off its mis-selling claims under sections 2(c) and 6(f) of its ISDA master agreement. The court rejected the set off claims under both provisions[7].
- There have been numerous attempts to avoid payment obligations by arguing a lack of legal capacity to enter into relevant derivative contracts in the first place. Claims of this type have been made in recent years by Italian[8] and Norwegian[9] municipalities, a Dutch housing association[10], and Portuguese hauliers[11], to name but a few. These have had varied success, and appeal court clarity is not expected until mid-2017 at the earliest.
- Lastly, there have been many allegations of mis-selling entitling counterparties to void their derivative contracts. Many of these claims have been brought by retail counterparties against financial institutions[12]. Of potential relevance now are arguments that there were breaches of advisory duties, failure to draw attention to key risks, and breaches of duties on regulated firms under the UK FCA's conduct of business rules or comparable foreign regulations. Some high profile cases of this type are still working their way through the courts.

There is little that can be done to stop a counterparty making creative arguments in litigation to delay or avoid paying a termination amount. Close outs should be approached with the risk of a dispute in mind, and maximum rigour applied to the close out process. Steps should also be taken to avoid creating damaging documents and communications, to make proper use of legal professional privilege, and to ensure nothing else is done that could jeopardise the position if litigation does ensue.

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5 See also *Fondazione Enasarco v Lehman Brothers Finance SA* [2015] EWHC 1307

6 *Pioneer Freight Futures Company Limited (in liquidation) v Cosco Bulk Carrier Company Limited* [2012] EWCA Civ 419

7 *MHB-Bank AG v Shanpark Ltd* [2015] EWHC 408 (Comm)

8 *Dexia Crediop S.p.A. v Commune di Prato* [2015] EWHC 1746 (Comm); *HSH Nordbank AG v Intesa Sanpaolo SpA* [2014] EWHC 142 (Comm)

9 *Haugesund Kommune v Depfa ACS Bank* [2010] EWCA Civ 579

10 *Credit Suisse International v Stichting Vestia Groep* [2014] EWHC 3103 (Comm)

11 *Banco Santander Totta SA v Companhia Carris de Ferro de Lisboa, SA* [2016] EWHC 465 (Comm)

12 *Thornbridge Ltd v Barclays Bank Plc* [2015] EWHC 3430 (QB); *Green v Royal Bank of Scotland Plc* [2013] EWCA Civ 1197; *Bailey v Barclays Bank plc* [2014] EWHC 2882 (QB)