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GMRAs – a review of two recent cases in the English High Court

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In this edition, we will focus on two recent cases in which the English Commercial Court has considered the termination and close-out provisions of the widely-used Global Master Repurchase Agreement (2000 version) known as the "GMRA".

In summary, under the GMRA, following an event of default, there is either an automatic termination arising from an Act of Insolvency, or, in any other scenario, the non-defaulting party must serve a notice of default, on the defaulting party, in writing. In those circumstances, default is effective when the Default Notice has been effectively served in accordance with paragraph 14.

Once a party is formally in default, the process of close-out starts. This has three stages:

1. First, all outstanding obligations due on repos documented under the same GMRA are accelerated for immediate settlement and all margin held by the parties is called back.
2. Second, the Default Market Values of the collateral are fixed and transactions costs added. The non-defaulting party can also add the costs of replacing defaulted repos and, if he considers it reasonable, the cost of replacing or unwinding hedges.
3. Third, all sums are converted into the same currency, and are netted off against each other to produce a single residual amount, which must be notified to the defaulting party.

The default procedure in the GMRA was thoroughly tested in the wake of the default of Lehman Brothers in September 2008 and the subsequent collapse of the Icelandic banking system. The two cases that I shall now be considering provide guidance as to how the English court has approached the GMRA's termination and close-out provisions.

Lehman Brothers International (Europe) v ExxonMobil Financial Services BV [2016] EWHC 2699 (Comm)

In Lehman Brothers against ExxonMobil, the Commercial Court ruled on issues arising out of a disputed close-out valuation under the GMRA following Lehman's default in September 2008.

Under the terms of the GMRA, Exxon purchased a portfolio of securities for approx. USD 250 million, with Lehman agreeing to repurchase the portfolio seven days later. The GMRA was rolled-over a number of times until September 2008, when Lehman entered administration. This administration was an event of default.

Validity of the default notice

In the circumstances, the Court was first tasked with determining whether and when a valid default notice had been served. This was necessary because under the terms of the GMRA the Default Market Value of repo securities can be ascertained by one of two routes, the first of which is time-limited in the sense that the notice has to be given within a certain window.

Under paragraph 10(e)(i) of the GMRA, the non-Defaulting Party can give a Default Valuation Notice in the period between the occurrence of an event of default and the default valuation

time (being close of business on the fifth dealing day after the day on which that event of default occurs). Exxon set out to follow this route.

Exxon's principal contention was that the communication it had sent (on 15 September 2008) was not compliant with GMRA because it did not refer to the administration; only that "an event of default" had occurred. It had in fact also sent a second notice the following day which did refer to the administration. However, Lehman rejected this argument, maintaining that the first communication sent on 15 September 2008 was a valid Default Notice so as to set time running.

Exxon argued that its first notice was ineffective in order to support its argument that a further Default Valuation Notice was sent in time. This is because if the default notice was effective a day later (i.e. 16 September), the deadline for sending the Default Valuation Notice would also be a day later (i.e. 23 September).

Pursuant to paragraph 2(1) of the GMRA, such a default notice required "*a written notice served by the non-Defaulting Party on the Defaulting Party under paragraph 10 stating that an event shall be treated as an Event of Default for the purposes of this Agreement*".

Mr Justice Blair determined that whilst a notice must clearly convey to the recipient that the non-Defaulting Party is treating an event as an Event of Default, there is no particular form of words prescribed and it therefore does not have to identify the specific event.

Moreover, even if it was necessary for the default notice to convey to Lehman the identity of the event relied upon; it was permissible, according to the judge, to take into account the background knowledge available to the parties. On this basis, the judge stated that he was "satisfied that given the background knowledge available to the parties on 15 September 2008, the [notice] of 15 September 2008 plainly conveyed that [Exxon] was relying on the appointment of administrators to [Lehman], just as it conveyed that [Exxon] wished to treat the event as an Event of Default. There really cannot have been any doubt about it". Exxon's first notice on 15 September 2008 was therefore deemed to be effective.

In the circumstances, the judge did not find it necessary to address the second default notice (or indeed Lehman's alternative case as to waiver and estoppel) save to indicate in obiter comments that email was a valid method of service under the GMRA principally because Lehman had included email addresses in Annex 1 to the GMRA setting out addresses for notices.

'Close of business'

Having ruled that Exxon's first notice on 15 September was effective, the judge was then required to resolve a further issue in relation to paragraph 14(b) of the GMRA. Paragraph 14(b) states that a notice received "*after close of business on the date of receipt or attempted delivery or on a day which is not a day on which commercial banks are open for business … shall be treated as given at the opening of business*" the following day. This was important because on the basis of the Judge's finding in respect of the first notice, the Default Valuation Notice was due by close of business on 22 September.

On the facts, Exxon signed a transition management agreement with JP Morgan on 16 September 2008 who would act on a best execution basis as transition agent to liquidate the portfolio. However, in the prevailing market conditions at the time, the sales proceeds turned out to be significantly lower than the pre-trade estimates and there was little interest in the bonds in the portfolio. It was understood by Exxon that the Default Valuation Notice had to be sent by close of business on 22 September 2008 and on that day it determined that its net shortfall was approximately $9.6 million. The Default Valuation Notice was duly sent at 5:54pm. It was received at 6:02pm.

Lehman claimed that Exxon's default valuation notice was invalid because it was sent to the wrong fax machine and in consequence the 'fair market value' provisions of the GMRA (which I shall address in more detail shortly) should therefore apply. Alternatively, Lehman argued

that if the notice was deemed to be valid, it was not valid until the following morning on 23 September because the notice was received at 6:02pm which was after close of business.

In the circumstances, rather than accept Exxon's shortfall calculations, on 24 April 2014, Lehman's solicitors notified Exxon that a balance of approximately $14 million was in fact due to Lehman.

As regards Lehman's contention that the Default Valuation Notice was invalid on the basis that it was sent to the wrong fax machine, the judge ruled that because the fax was in any event received and logged by Lehman in the usual way, and no point was taken that it was invalid at any time until Lehman amended its case in May 2015 – it was too late for it to take this point. The judge remarked that "*if a point as to the fax number that a notice is sent to is to be taken, it should be taken promptly*".

On the basis that the Default Valuation Notice was deemed to be valid, the judge then dealt with Lehman's alternative argument in respect of it allegedly being sent after 'close of business' on 22 September. On this point the judge ruled that the term 'close of business' offered a useful flexibility and was dependent upon the specific circumstances, and that in the context of financial business of the kind at issue, 5pm would be too early. The judge therefore accepted Exxon's expert evidence that a close of business time of 7pm was a more reasonable and commercial interpretation given the "*more all-consuming hours worked by investment bankers, commercial lawyers and the like*". Exxon's Default Valuation Notice, which was received by Lehman at or shortly after 6:02pm was therefore found to have been received prior to the close of business in London on 22 September 2008 (which was the fifth dealing day after the event of default and therefore in accordance with GMRA).

Practitioners should therefore consider, where possible, specifying a cut-off time in order to avoid disputes of this nature.

Conclusion

As a result of these conclusions; namely that Exxon's first notice on 15 September and subsequent default valuation notice on 22 September were validly served, the judge then had to determine some high level points of principle on valuation. However, given the size of the portfolio, the court was not asked to carry out a security-by-security valuation or to calculate values for any security, instead the parties submitted a document agreeing high-level points of principle which each party asked the court to decide.

Of key importance and relevance was the judge's conclusion that the non-defaulting party's valuation needed to be rational rather than objectively reasonable, and this point will be developed in the second case I am going to consider.

LBI EHF v Raiffeisen Zentralbank Österreich AG & Raiffeisen Bank International AG [2017] EWHC 522 (Comm)

This is a recent decision of the Commercial Court involving LBI EHF (formerly Landsbanki Islands hf) and Raiffeisen Zentralbank (RZB). Stephenson Harwood LLP successfully represented RZB in these proceedings.

LBI brought the claim against RZB arising out of the close-out in October 2008 of repo and securities lending transactions entered into by the parties.

On 7 October 2008, following the collapse of the Icelandic banking system the Financial Supervisory Authority of Iceland appointed a Resolution Committee to manage the affairs of LBI. This was an event which RZB was entitled to declare an Event of Default under both a GMRA and a Global Master Securities Lending Agreement (GMSLA).

Service by fax

The next day, RZB sent Default Notices to LBI by fax. LBI denied that either notice was received by a responsible employee of LBI, and hence contended that neither notice was effective.

Paragraph 14(b)(iii) of the GMRA and paragraph 21.1(iii) of the GMSLA both provide that a notice sent by fax will be deemed effective when:

"the transmission is received by a responsible employee of the respondent in legible form (it being agreed that the burden of proving receipt will be on the sender and will not be met by a transmission report generated by the sender's [fax] machine)."

Mr Justice Knowles therefore assessed whether, on the balance of probabilities, RZB's faxes were received by a responsible employee of LBI in legible form. On the basis of the factual evidence of the parties, the judge concluded that:

(a) the faxes were sent by RZB to the relevant fax number;

(b) there was a greater likelihood of the faxes being received in legible form rather than illegible form; and

(c) the faxes were collected by an employee with responsibility for collecting them.

LBI contended that "responsible employee" meant "an employee with the responsibilities relevant to the default i.e. someone who will recognise a … notice for what it is, and what steps will be taken as a result". However, Mr Justice Knowles concluded that LBI's interpretation of the clause read "far too much into the phrase" as it would allow the quality of the recipient's systems and procedures to affect the position considerably and it was not accepted that the parties would intend such uncertainty.

Valuation

Since an Event of Default had occurred under the GMRA and the GMSLA on 8 October 2008, the remaining issue was the subsequent close-out valuations in relation to the GMRA trades (there was no valuation issue in relation to the GMSLA trades).

No Default Valuation Notice (as defined by the GMRA) was served by RZB by the Default Valuation Time of 15 October 2008. In those circumstances the GMRA provided, by paragraph 10(e)(ii) that:

"…the Default Market Value … shall be an amount equal to their Net Value at the Default Valuation Time; provided that, if at the Default Valuation Time the non-Defaulting Party reasonably determines that, owing to circumstances affecting the market…, it is not possible for the non-Defaulting Party to determine a Net Value … which is commercially reasonable, the Default Market Value … shall be an amount equal to their Net Value as determined by the non-Defaulting Party as soon as reasonably practicable after the Default Valuation Time."

Moreover, paragraph 10(d)(iv) of the GMRA defines "Net Value" as:

"…the amount which, in the reasonable opinion of the non-Defaulting Party, represents their fair market value, having regard to such pricing sources and methods (which may include, without limitation, available prices for Securities with similar maturities, terms and credit characteristics as the relevant ... Securities … shall be an amount equal to their Net Value as determined by the non-Defaulting Party as soon as reasonably practicable after the Default Valuation Time."

In the event, as soon as the GMRA Default Notice had been dispatched to LBI, RZB asked for bids from 10 institutional counterparties. It also enlisted its own traders and sales people to help sell the positions. The response RZB received supported a decision by RZB to place orders to sell, setting a price or limit. At the time and in the distressed market circumstances prevailing, RZB did not consider the prices shown on Bloomberg to represent a practical and commercial realisable value. This view was based on its experience following the Lehman default in September 2008. LBI however argued that RZB should not have carried out a determination of value based on prices obtained/obtainable in a distressed market. Mr Justice Knowles did not accept this.

Mr Justice Knowles considered that the task for the court (citing the leading cases of Socimer Bank v Standard Bank and the Lehman ExxonMobil case discussed earlier) was to put itself into the shoes of the decision maker (i.e. RZB, the non-Defaulting party) and ask what decision RZB would have reached, acting rationally and not arbitrarily or perversely.

Mr Justice Knowles considered RZB's submissions as to fair market value based on the information actually available to it on 15 October 2008 regarding the valuation of the securities. The judge was prepared to accept that RZB's figures (including the adjustments it applied for the positions closed out after 15 October 2008) met the requirement for a rational, honest determination of fair market value as at 15 October 2008.

It was common ground that on those figures LBI's claim was bound to fail, so the claim was dismissed.

Conclusion

This case therefore reaffirms that the non-defaulting party, particularly in a distressed market, is afforded a wide amount of contractual discretion in reaching a determination on "fair market value" subject to it acting rationally and not arbitrarily or perversely.

However, LBI have appealed this decision and argued (amongst other things) that the judge should have accepted its construction of "fair market value" as requiring the non-defaulting party to arrive at a value which was separate from and not reflective of a distressed or illiquid market. Given that there is no other authority on the meaning of "fair market value" in the default provisions and in particular in the definition of "Net Value" in the GMRA, LBI was granted permission to appeal by the Court of Appeal on this point only. The appeal is listed to be heard in early 2018.