ISDA Master Agreements

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In this webcast I am going to talk about two recent decisions concerning the Courts' approach to interpreting some of the standard terms contained within the ISDA documentation.

The first case (***Lehman Brothers Finance AG (in liquidation) v Klaus Tschira Stiftung GMBH & Anor [2019] EWHC 379 (Ch)***) I am going to consider relates to the High Court's approach to determination of "Loss" following an "Automatic Early Termination Event" under the 1992 ISDA Master Agreement. The second case relates to the Court's interpretation of the standard form ISDA Credit Support Annex.

Under the 1992 ISDA Master Agreement, following an event of default, there is either an automatic termination or the non-defaulting party can serve a notice designating an Early Termination Date. There then has to be a determination by the non-defaulting party of the compensation that is owed by one party or the other. This is done by closing out the transactions, which involves determining gains or losses in replacing or providing the economic equivalent of the terminated transactions. Once that is done, a statement is served setting out the calculations.

In the case of Lehman Brothers Finance AG (in liquidation) and Klaus Tschira, Mr Justice Snowden held that the defendants' Loss Calculation was not in accordance with the close-out provisions of the 1992 ISDA Master Agreement, and that it was not binding upon Lehman.

By way of background, on 16 May 2007, the parties entered into variable forward sales and purchases transactions which were undertaken pursuant to 1992 ISDA Master Agreements. The terms of these transactions required the defendants' principal asset - a large volume of shares in S.A.P. (a charitable organisation) – to be placed as collateral with Lehman.

On Monday, 15 September 2008, the bankruptcy of the Lehman group gave rise to an Automatic Early Termination of the Master Agreements under section 6(a). As a consequence, an Early Termination Date occurred on 15 September 2008.

The payment measure that the parties elected to use in such circumstances was "Loss" (as opposed to "Market Quotation"). In this context, the 1992 ISDA Master Agreement states that "*a party may determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets*". Accordingly, the defendants sought indicative quotations from Mediobanca and were advised that if the replacement transactions were priced as at the close of the Frankfurt Stock Exchange (the FSE) on 12 September 2008, they would have to pay Mediobanca a combined total of 7.45 million EUROS, whereas if they were priced as at the opening of the FSE on 15 September 2008, they would have had to pay Mediobanca a combined total of 28.22 million EUROS.

In addition to this, the defendants sought indicative quotations from Goldman Sachs. On the basis of Goldman Sachs' valuation of the cost of replacements for the transactions as at the opening of business on 15 September 2008, the defendants would have had to make a net payment to Goldman Sachs of 17.46 million EUROS.

On 25 September 2008, the defendants collated the information they had received from Mediobanca and Goldman Sachs. This resulted in an aggregate net payment of about

22.84 million EUROS by the defendants to a counterparty, i.e. a close-out payment of this amount was required from Lehman to the defendants.

However, in the knowledge that the S.A.P. shares fell to be dealt with by the Joint Administrator of Lehman in the course of the administration (and, therefore, were essentially inaccessible), and in the light of the volatility of the S.A.P. share price, the defendants also sought to calculate their Loss on an uncollateralised basis. Mediobanca provided a quotation on this basis, as at the close of the FSE on 16 October 2008, which resulted in net amounts payable to it of 511.13 million EUROS (the increased amount reflecting the fact that Mediobanca would have increased exposure in the absence of any collateral).

The defendants proceeded with this more attractive figure, and set out their formal calculation of Loss in a letter to Lehman that was sent on 16 December 2008, which I shall refer to as the "**Loss Calculation**".

Lehman challenged the defendants' Loss Calculation. Lehman contended that:

- the defendants did not determine their Loss reasonably or in good faith in accordance with the requirements of the ISDA Master Agreements;
- the Loss Calculation was based on a valuation of materially different (i.e. non-collateralised) transactions which the defendants could never have entered into; and
- the defendants' valuation should have been obtained by reference to the Early Termination Date itself, and ought to have been for collateralised replacement transactions.

In response, the defendants contended that:

1. the ISDA Master Agreements did not prescribe the method that they had to use to determine Loss, and did not require them to base their determination on live market quotations;
2. the ISDA Master Agreements simply required them to determine an amount that would be required to put themselves into the position that they would have been in if the transactions had not terminated; and
3. their approach was reasonable and honest unless Lehman could demonstrate that no Non-Defaulting Party acting reasonably and in good faith could have acted in the same way.

The Court was therefore tasked with determining whether the defendants' Loss Calculation was made in accordance with the ISDA Master Agreements and hence was contractually valid and binding on Lehman.

The defendants placed considerable reliance upon what they contended was the deliberately non-exhaustive definition in the ISDA Master Agreement when it came to prescribing a specific methodology for determining Loss. The defendants contended that a determination of Loss is what the non-defaulting party "*reasonably determines in good faith to be its total losses and costs … in connection with the termination transactions*".

The Judge accepted that the text of the 1992 ISDA Master Agreement was designed to give the non-defaulting party discretion and flexibility in selecting the method for calculating its Loss, subject to such methodology being reasonable and in good faith (in accordance with the established common law principles relating to contractual damages and remoteness). It was also accepted that a non-defaulting party has a degree of latitude as to when it is obliged to obtain quotations in order to reflect the problems that might arise in practice. However, the Judge did not agree that the non-defaulting party has similar freedom to decide what matters can be included within the meaning of Loss.

The Judge therefore rejected the argument that:

it was up to the defendants to decide for themselves what "Loss" meant in the Master Agreement; and

Lehman should be deemed to have agreed to be bound by the defendants' own interpretation of "Loss".

The Judge explained that it would not have been within the reasonable contemplation of the parties that the S.A.P. shares would be inaccessible in the event of a default by Lehman. It was also not rational for the Loss Calculation to be determined on an uncollateralised basis. As such, the Loss Calculation was not contractually valid or binding on Lehman as the terminated transactions should have been valued on the basis of collateralised replacement transactions.

Having determined that the defendants' Loss Calculation was not in accordance with the ISDA documentation and not binding on Lehman, the Judge turned to the question of what would have happened if a reasonable person in the position of the defendants had correctly performed their task of determining Loss under the Master Agreements. He considered that such determination should have been based upon quotations or valuations for collateralised replacement transactions as of a date as soon as reasonably practicable AFTER the Early Termination Date, and that the valuations from Mediobanca and Goldman Sachs both fulfilled those requirements.

The Court's approach was that it should not readily become involved in a detailed assessment of whether the determining party took into account all relevant factors when determining its loss as this would encourage challenges to be made to the calculation by the non-defaulting party, which would cut across the desire for speed and commercial certainty of determination. It follows that a non-determining party must be given latitude and flexibility in choosing the method by which they should determine 'Loss', as long as the requirements of rationality and good faith are satisfied. This freedom also extends in certain (limited) circumstances to the determination using valuations prepared by reference to a date which is some time after the Early Termination Date.

However, the case makes clear that there are limits on what the non-defaulting party can do when calculating Loss, and that it does not have a complete freedom to decide what matters can be included within the meaning of Loss.

The second case I am going to consider is The State of The Netherlands and Deutsche Bank. (***The State of The Netherlands v Deutsche Bank AG [2019] EWCA Civ 771***)

In early 2001, the parties entered into an ISDA Master Agreement and Credit Support Annex, which I shall refer to as the CSA. The interest rate in the CSA was a low one (EONIA minus 4 basis points). In 2014, the interest rate fell below zero, where, for the most part, it then remained. The State argued that where the Interest Amount for any given period was negative, the Bank effectively has to pay "negative interest" to the State (by including negative unpaid interest in the calculation of the Credit Support Balance). The Bank disagreed and argued that it was never intended that "negative interest" would be paid. The contractual documentation itself made no reference to "negative interest", possibly because it was simply not contemplated as a possibility at the time.

At first instance, the Commercial Court agreed with the Bank that it was not required to pay negative interest. Mr Justice Knowles stated that if payment of negative interest were a contractual obligation, it would have been spelled out. In particular, the Judge examined the following provisions of the CSA:

1. A paragraph in the CSA provided that only the Bank was defined as the "Transferor" and only the State as "Transferee"

The interest obligation in the CSA stated that "*the Transferee will transfer to the Transferor … the … Interest Amount*"

The definition of "*Credit Support Balance" provided that any: "Interest Amount … not transferred … will form part of the Credit Support Balance*"

Mr Justice Knowles concluded that the only reference to interest was the payment of the Interest Amount by the transferee (i.e. the State). He rejected the State's argument that the definition of the Credit Support Balance contemplated accounting for negative interest by the Bank to the State because:

1 it was not explicitly spelled out; and

2 there was no credible commercial rationale for the parties to have opted to deal with positive and negative interest in such significantly different ways.

The State appealed Mr Justice Knowles' decision. However, the Court of Appeal concluded that Mr Justice Knowles had reached the right decision, albeit by the wrong method. In finding for the Bank because of the lack of an explicit reference to the payment of negative interest, it concluded the Judge had: "*adopted too simplistic an approach*". Going further, the Court of Appeal decided that in fact the language of the contractual documentation could, in theory, provide for the payment of negative interest.

In deciding that ultimately it did NOT bear that meaning, the Court of Appeal referred to the key issues:

1 The 2010 ISDA Best Practice Statement (which was not put before Mr Justice Knowles) provided that: "*at no point should the interest accrual drop into a negative figure. If this occurs the rate should be floored at zero.*" The Court deemed this was relevant in showing "*ISDA's thinking*" and could not be ignored in the question of interpretation.

2 Both sides argued that the contract could have explicitly clarified the position one way or another. The starting point on interpretation had to be, however, what the drafting did include, rather than what it did not.

3 A series of hypothetical "asymmetries", identified by Counsel for the Bank, if the State's interpretation were correct, had significant force.

4 Looking at the contractual documentation as a whole, the Court concluded there was nothing to give: "*the impression that negative interest was contemplated or intended*".

The Court of Appeal's analysis was similar to but different from the Commercial Court's. Rather than focussing on the absence of an express obligation to pay negative interest, it took more account of overall context.

The most interesting element of the analysis is the use made of ISDA guidance. Rarely are POST-contractual documents permissible as an aid to interpretation. Here, it seems that precisely because the parties were using standardised ISDA documentation the Court was prepared to attach weight to the guidance provided by ISDA. In particular, it was influenced by the fact that the 1999 ISDA User's Guide (the pre-contractual guidance) made no reference to negative interest rates and that when the possibility of such a rate arose, ISDA provided guidance to the effect that it should be floored at zero instead of dropping into a negative figure.

While the Court's attention was drawn to the "Background" note to the 2014 ISDA Negative Interest Protocol (suggesting that from a commercial perspective, it was thought important that "negative benchmark rates" should in some circumstances flow through to ensure "economic consistency" in the derivatives market), this was not construed as meaning the CSA should be interpreted to account for negative interest.

Rather, it was considered supportive of the fact that ISDA recognised that the standard terms of the CSA did not provide for the payment of negative interest.

More practically, the decision is of significance for endorsing the conclusion (albeit on different grounds) of the Commercial Court that, unless expressly provided otherwise, negative interest is not payable under the standard ISDA CSA.