BANKING AND FINANCIAL SERVICES LITIGATION GROUP WEBCAST SERIES 2018

ISDA Master Agreements

Jeremy Livingston, associate

In this webcast, I am going to talk about two recent decisions concerning ISDA Master Agreements.

The first case I am going to consider is an English Commercial Court judgment in Lehman Brothers Special Financing (LBSF) and National Power Corporation (NPC) (*Lehman Brothers Special Financing Inc. v National Power Corporation & Anor [2018] EWHC 497 (Comm)*) in which the court primarily considered the following two points:

1. First, whether, following an Event of Default, it was open to the Determining Party under an ISDA Master Agreement to re-make a determination of the Close-Out Amount after its initial determination; and

2. Second, whether the changes in the wording relating to close-out between the 1992 and 2002 versions of the ISDA Master Agreement had the effect of replacing a requirement for a rational decision on the part of the Determining Party with a requirement for an objectively reasonable decision.

By way of background, the transaction in question was a principal-only US Dollar-Philippine peso forward currency swap under the 2002 version of the ISDA Master Agreement. NPC had issued 300 million US Dollars of bonds maturing in 2028 and the currency swap was part of its hedging strategy in connection with the bond issue.

As part of the swap transaction, an option was granted by LBSF to NPC under which NPC could choose to pay 1m US Dollars on 15 May 2008 instead of paying the US Dollars equivalent of 4.5 billion Philippine pesos in 2028. However, NPC did not exercise the option.

LBSF had provided mark to market valuations of the transaction, including, on 17 September 2008, a mark to market valuation of 16.5m US Dollars in LBSF's favour. In an internal memo, NPC had recorded in September 2008 that it was out of the money.

LBSF filed for bankruptcy on 3 October 2008, which amounted to an Event of Default under the swap. Accordingly, NPC served notice of early termination on 17 October 2008, designating the Early Termination Date as 3 November 2008. It was therefore for NPC to calculate the Early Termination Amount (which in turn is based on the Close-Out Amount). Rather than just getting quotations, NPC looked to replace the gap in its hedging strategy by seeking to enter into a replacement transaction.

On 7 November 2008, NPC received firm quotations from three banks. In the end, on 14 November 2008, NPC entered into a replacement transaction with UBS, which included an option with an exercise date of 16 November 2009.

Based on the UBS transaction, on 26 January 2009, NPC demanded approximately 3.4m US Dollars from LBSF, and enclosed its calculations in an annex. NPC then filed a proof of claim for payment of this Early Termination Amount in LBSF's bankruptcy proceedings. However, in September 2014 it withdrew the proof of claim and served a revised calculation statement in October 2016. The revised statement included both a "primary determination" and an "alternative determination". The former was of 10.7m US Dollars and the latter of 2.1m US Dollars, in each case payable by LBSF to NPC. The "primary determination" was based on an indicative quotation from UBS, and the "alternative determination" was based on the actual UBS transaction (i.e. on the transaction that was entered into, and which included an option). LBSF objected and said (based on expert evidence) that it was owed 12.8m US Dollars by NPC.

The first question for the Court was whether or not NPC was entitled to withdraw its initial statement and rely on a revised figure. NPC argued that the amount in the annex to its first statement was not an amount equal to the Close-Out Amount because it did not accord with the definition of Close-Out Amount, in particular because it failed to account for a portion of the semi-annual fixed sum payments under the swap. It was, NPC said, therefore invalid and not contractually binding. LBSF, on the other hand, argued that there was no entitlement to withdraw and replace a calculation once served under section 6(d)(i) of the 2002 ISDA Master Agreement.

On this question the judge found that the Master Agreement should be construed as follows:

1. By delivery of its letter of 17 October 2008, NPC caused a debt obligation to arise, and the 26 January 2009 letter with the calculations caused an obligation to pay to arise;
2. Once these events had occurred, the relationship between the parties was affected, and not reversible (save by agreement of the parties or in some cases an order of a court);
3. NPC was required to make a determination, and it determined that approximately 3.4 million US Dollars was payable. This completed its obligation and right to make a determination; and
4. If there was an error in that determination, then the Court would be left to declare that, and to state what the Close-Out Amount would have been without the error.

According to the Judge, this approach reflects the certainty that the parties must have intended.

In this case, although the "Accrued Amount" was not taken into account, that was an error that only permitted the determined figure to be corrected, by agreement or by the Court, but only in the respect in which there was an error. In other words, a determination had been made and the determination as a whole was not liable to be reopened and recalculated all over again.

Turning now to the second question for the Court; namely, whether a requirement in the 1992 ISDA Master Agreement for a rational decision on the part of the Determining Party had been replaced in the 2002 form with a requirement for an objectively reasonable decision, it was first necessary to consider the definition of the Close-Out Amount in the 2002 ISDA Master Agreement.

This provides that *"any Close-Out Amount will be determined by the Determining Party (or its agent) which will act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result*".

In a previous Lehman case, the Court had said that this provision imposes two objective standards – the first is that the procedures used should be commercially reasonable, and the second is that the result produced should also be commercially reasonable. NPC had argued that the definition of Close-Out Amount required only that the Determining Party use rational procedures in order to produce a rational result. The Court disagreed. The judge pointed out that the wording in the 2002 ISDA Master Agreement had changed from the 1992 version, which defined "Loss" by including the words "*an amount that a party reasonably determines in good faith to be its total losses and costs*". Previous case law had found that this required the calculating party to act rationally, but not necessarily objectively reasonably. The Court found that the change to the wording from the 1992 form to the 2002 form was material. The 2002 User's Guide also made clear that the change in the wording was specifically designed to include the notion of "objectivity". Although NPC had argued that the requirement for a "wholly objective approach" would deprive the Determining Party of the benefit of the discretion, the judge disagreed saying that he was not convinced that a "discretion" was given at all, but that in any event there was a benefit in terms of control of the decision-making process.

Taking all this into account, the Court found that the Determining Party was required to use procedures that were, objectively, commercially reasonable in order to produce, objectively, a commercially reasonable result. It if does not do this, then the Court will.

The Court concluded that it was commercially reasonable for NPC to rely on the UBS transaction (and NPC was effectively stuck with it). The mark to market valuations did not assist as they were not the same as the price at which a replacement transaction could be achieved, and all the banks who provided a quotation did so at a price that was very different from the mark to markets and always at a cost to LBSF rather than NPC. Where a firm quotation existed from UBS it was appropriate to regard that as having superseded the indicative quotations, and the firm quotations from the other banks were in line with UBS's quotation. As for the fact that the UBS replacement transaction replaced more than the LBSF transaction, because it included an option that NPC did not have as at the Early Termination Date, the judge found that this made no material difference, save that NPC was not entitled to pass on to LBSF the option exercise price of 1m US Dollars.

The judge concluded the case by pointing out that the dispute demonstrated the range of possible outcomes when parties are calculating Close-Out Amounts, and the wisdom of ISDA making the changes that it did in the 2002 form. NPC illustrated the type of outcome that a party given the role of decision maker and limited only by a requirement of rationality might press for, regardless of the fact of an actual replacement transaction.

This case confirms that the non-defaulting party, calculating the Close-Out Amount following an Event of Default under the 2002 form, is required to act objectively reasonably, and produce an objectively commercially reasonable result – rather than just being required to act "rationally". Practically, this means that although there might still be a range of possible valuations, it is not open to the non-defaulting party just to choose the valuation which best suits it. Moreover, if a replacement transaction is actually entered into, then it appears from the judgment that it is going to be difficult for either party to challenge a Close-Out Amount which is based on that replacement transaction.

The decision also clarifies that once the Early Termination Amount has been calculated and notified, absent a substantive mistake or a failure to follow the provisions of the Master Agreement, it is not going to be possible for the non-defaulting party later to change its mind and seek to rely on a different Early Termination Amount. It is therefore important that care is taken, when serving a calculation notice under section 6(d)(i) of the 2002 ISDA Master Agreement, to ensure that it is "objectively reasonable".

The second case I am going to consider briefly is the recent English Commercial Court decision in The State of The Netherlands ("**the State**") and Deutsche Bank (*The State of The Netherlands v Deutsche Bank AG [2018] EWHC 1935 (Comm)*), in which the Court ruled that the standard form ISDA Credit Support Annex ("**CSA**") does not include an obligation on a Transferor to account for negative interest, where the ISDA 2014 Collateral Agreement Negative Interest Protocol (which I shall refer to as the "**ISDA Protocol**") has not been explicitly incorporated.

On 14 March 2001, the parties entered into a 1992 ISDA Master Agreement, Schedule and CSA. The parties subsequently entered into a number of derivative transactions. In a situation where the State had a net credit exposure to Deutsche Bank under these transactions, the CSA required Deutsche Bank to provide credit support to the State (note, though, that the CSA had been amended by the parties so that the State was not required to post collateral – i.e. only Deutsche Bank was, if due). This credit support was provided by Deutsche Bank in the form of cash collateral and the documents required the State to pay interest on that cash collateral at a rate of EONIA (Euro OverNight Index Average) minus 0.04%. However, since 13 June 2014, EONIA was mostly less than zero. The question for the Court was, therefore, whether the parties' agreement required Deutsche Bank to pay "negative interest", i.e. interest from the party who provides a principal sum (the Transferor) for a period of time, rather than the party that receives it and has the use of it for a period of time.

The Court rejected the State's arguments and found that the CSA does not contemplate a legal obligation on the part of the Transferor to account for negative interest when no such obligation had been spelled out.

In short, the reasons for this were as follows:

1. The fact that the definition of "*Interest Amount*" in the CSA is capable, as a matter of language, of allowing for a negative figure is only a starting point – it is necessary to look at the documentation as a whole.
2. The Judge relied heavily on section 5(c)(ii) of the CSA, which envisages payment of interest from the Transferee (here the State) but not from the Transferor (Deutsche Bank). In other words, it contemplates the transfer of interest by the person holding the collateral to the other person who posted it. If there were an obligation on the Transferor, the Judge found, it would be spelled out.
3. The State relied on the final sentence of the definition of "Credit Support Balance". It argued that the bank was therefore obliged to "account" for negative interest rather than transfer it. The Judge found that this wording could not give rise to or reflect an obligation on the Transferor when no such obligation had been spelled out.
4. There were commercially rational reasons why the parties would have been concerned only with interest where it is positive – for example, it had the benefit of simplicity. Also, where cash collateral could be expected to generate money simply by being held, some reflection of that benefit should be received by the Transferor. But it did not follow that the parties intended that where cash collateral would *lose* money, that some reflection of that burden should be shouldered by the Transferor.
5. The State also relied on the ISDA Protocol. However, that was not available to the parties when they made their agreement, so could not assist in the construction of that agreement – but anyway it did not assist the State as it envisaged an *amendment* to achieve its ends.

In conclusion, this decision is perhaps not surprising, and the Judge's conclusions are logical and sensible, but it does provide welcome clarification on an issue that has caused uncertainty in the market. If parties intend for negative interest to be payable, they need to make express provision for this. This can be done by either adhering to the ISDA Protocol or by including a bespoke provision (for example, by amending section 5(c)(ii) of the CSA).