Feature

KEY POINTS

- The 2002 ISDA Master Agreement requires that the determining party must use objectively reasonable process to reach an objectively reasonable result when calculating the Close-out Amount. This contrasts with the 1992 ISDA Master Agreement where English courts have found the more subjective standard of "rationality" applies.
- Nevertheless, if a party can obtain a firm quotation or a replacement transaction, it will be in a very strong position under either the 2002 ISDA Master Agreement or the 1992 ISDA Master Agreement.
- Mark-to-market valuations and models presented by the party challenging a Close-out calculation are not evidence for the price at which a replacement transaction would have been available in the market where they differ from actual quotations obtained from leading dealers in the market at the relevant time, reinforcing the truth of the observation by Schuyler Henderson that in a close-out "you really do want to be the determining party".

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Close-out provisions under the 2002 Master: You still want to be the determining party

The recent high court judgment in *Lehman Brothers Special Financing Inc v National Power Corporation and another* [2018] EWHC 487 (Comm) considered a contested Close-out Amount determination under the 2002 ISDA Master Agreement. The judgment which contrasted key aspects of the Close-out Amount definition with Loss under the 1992 ISDA Master Agreement draws some significant distinctions between the two but also points to several common themes that are emerging from valuation disputes.

FACTUAL BACKGROUND

The case concerned a forward currency swap between Lehman and a Philippines company, National Power Corporation (NPC), whereby Lehman agreed to pay US$100m to NPC in 2028 and NPC agreed to pay the US dollar equivalent of PHP4.4788bn on the same date. NPC was also to pay semi-annual coupons to Lehman at a fixed rate.

NPC terminated the transaction following the collapse of Lehman and designated an Early Termination Date of 3 November 2008. On 3 November 2008, NPC obtained indicative quotations from three leading market dealers, including UBS. NPC proceeded to firm quotations from each of the leading market dealers on 7 November 2008 and entered a replacement transaction with UBS on 14 November 2008.

On 26 January 2009, NPC submitted a calculation notice demanding payment from Lehman of around US$3.5m, based on the transaction actually entered into with UBS. Among other things, the UBS transaction included an option exercisable in November 2009.

Although the Lehman transaction included a similar option, it had expired prior to the Early Termination Date. Both parties ultimately agreed that the expiry of the option under the Lehman transaction should properly be taken into account when calculating the cost of a replacement.

Lehman subsequently commenced legal proceedings seeking payment from NPC in the sum of around US$13m. Lehman alleged, among other things, that NPC had neither used "commercially reasonable procedures" nor reached a "commercially reasonable result" as it contended was required by the 2002 ISDA Master Agreement (the 2002 Agreement).

In 2016, some time after proceedings had been commenced, NPC purported to withdraw its calculation statement. It served a revised statement which included what NPC termed a "Primary Determination" and an "Alternative Determination". The "Primary Determination" stated that around US$10.8m was due from Lehman based on the indicative quotation provided by UBS. The "Alternative Determination" stated that around US$2.1m was due from Lehman to NPC, based on the transaction actually entered into with UBS. Unlike the original calculation, both the Principal Determination and the Alternative Determination took into account the fact that the option in the original Lehman transaction had expired.

DOCUMENTARY BACKGROUND

The Close-out Amount definition in the 2002 Agreement was intended to introduce substantive changes to the determination of amounts owed on termination of transactions as compared to determinations under the 1992 ISDA Master Agreement (the 1992 Agreement).

The 1992 Agreement provides two possible measures for calculating the sums payable upon termination: Market Quotation and Loss. The Market Quotation provision sets out a prescribed method under which quotes for a replacement transaction are obtained from at least three reference market makers. If Market Quotation is specified but cannot be determined or "would not (in the reasonable belief of the party making the determination) produce a commercially reasonable result", the Determining Party must instead use the more flexible Loss method to calculate the sums payable. The parties could equally specify from the outset that the Loss method is to be used for all terminated transactions. The definition of Loss requires the Determining Party to calculate "an amount that [it]

reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) ….". The Loss definition specifically allows (but does not prescribe) the Determining Party to calculate by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets.

It is now established that a calculation of Loss can be challenged successfully only if it represents "a determination which no reasonable Non-defaulting Party could come to".[1] This standard has been described as a standard of "rationality" or "Wednesbury reasonableness".

In contrast to the 1992 Agreement, the Close-out Amount definition in the 2002 Agreement provides a single method of calculating the payments due on termination. It contains several permissive terms allowing the Determining Party flexibility to use indicative quotations, market data and models. None of these are expressly permitted under Market Quotation or Loss in the 1992 Agreement and the prevailing English case law has cast significant doubt over whether indicative quotes, for example, can be used when calculating Loss. The Close-out Amount definition also 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 to reach a commercially reasonable result."

The User's Guide to the 2002 Agreement gave the following rationale for these changes to the 1992 Agreement:

> "Balanced by the interest of increased flexibility was the need to ensure that the new provision incorporated certain objectivity and transparency requirements that were felt to be lacking, particularly in the definition of Loss."

OBJECTIVITY AND THE MEANING OF REASONABLENESS

Notwithstanding the efforts to introduce additional objectivity and transparency into the Close-out provisions in the 2002 Agreement, NPC argued that a determining party under the 2002 Agreement was still bound only by a standard of rationality or Wednesbury reasonableness.

The primary basis for this argument was the decision in *Lehman Brothers International (Europe) v Lehman Brothers Finance S.A.*[2] where the court considered a hybrid document which incorporated terms from both the 1992 Agreement and 2002 Agreement. In that case, Briggs J found that the wording in the Close-out Amount definition imposed two objective standards. The first was that the procedures used to calculate the Close-out Amount should be commercially reasonable and the second was that the result should be commercially reasonable. However, Briggs J also added that:

> "Plainly that leaves a bracket or range both of procedures and results within which the Determining Party may choose, even if the court carrying out the exercise itself, might have come to a different conclusion."[3]

NPC argued that by referring to the Determining Party's choice, Briggs J meant that the decision as to which particular outcome was appropriate was a subjective matter for the decision maker. Accordingly, the only requirement was that the Determining Party use rational procedures which would produce a rational result.

The Court of Appeal in *Socimer v Standard Bank*[4] endorsed the concept that, where a discretion is granted to one of the parties under a commercial contract, that discretion will be limited by a standard of rationality rather than a more objective standard such as when a party is required to take reasonable care. That case involved forward sales of emerging markets securities on documentation which provided simply that the value of the assets to be liquidated or retained "shall be determined on the date of termination by the Seller". The court in *Socimer* drew a key distinction. Where, for example, there is an implied term that a reasonable price or a reasonable time is to be fixed, the concept of reasonableness is intended to be entirely mutual and the decision maker effectively becomes the court. In those circumstances the appropriate standard is one of objective reasonableness. Where, however, the right to make the determination is awarded to one of the parties to the contract, a standard of rationality will apply and the decision remains that of the decision maker. The court in *Socimer* ruled that the provision before them was one that was limited only by rationality.[5]

NPC argued that, since the 2002 Agreement tasked one of the parties (the Determining Party) with determination of the Close-out Amount, the decision remained with the Determining Party and the correct test is one of rationality.

Knowles J, however, rejected this argument, finding that, while the choice of decision maker may to some degree inform the conclusion about the nature of decision making, the choice to make a party to the contract a decision maker does not necessarily compel a conclusion that "reasonableness" is deployed to mean rationality. That will depend on the wording and context.

Knowles J found the change to the wording from the 1992 Agreement to the 2002 Agreement to be material. He focussed, in particular, on the fact that the 2002 Agreement required for the first time that the calculation of liabilities on closing out had to be carried out "in order to produce a commercially reasonable result".[6]

Knowles J's ruling has potential implications beyond the 1992 Agreement and the 2002 Agreement. First, his decision serves as a further example that the English courts will seek to give meaning to all of the words chosen by the parties to be included in a contract. Knowles J was clear that he considered the wording chosen for the 2002 Agreement to carry with it a higher standard than was intended by the 1992 Agreement which provided for "reasonableness" rather than "commercial reasonableness" and made no reference to the Determining Party reaching a (commercially) reasonable result. This suggests that parties should be careful which standard of reasonableness they are selecting when including particular forms of words in their contracts.

REPLACEMENT TRANSACTIONS AND THE USE OF INDICATIVE QUOTATIONS

Informed by his ruling on the standard of reasonableness to be applied, Knowles J determined that NPC's 2016 Primary Determination did not satisfy the requirements of the 2002 Agreement but that the Alternative Determination did so.

Taking into account the market circumstances in late 2008, Knowles J found the UBS firm quote and replacement transaction to be stronger evidence of the Close-out Amount than the indicative quotes.[7] Accordingly, it would not have been commercially reasonable to use the indicative quotes as the basis for calculating the Close-out Amount, even though the indicative quotations would have allowed a calculation as at the Early Termination Date.

In making this ruling, Knowles J is far from being alone. Firm quotes and replacement transactions have equally been found to be stronger than other evidence when considered in the context of both Market Quotation and Loss.[8]

It, therefore, remains the case that, if a party can obtain a firm quotation or a replacement transaction, it will be in a very strong position under either the 2002 Agreement or the 1992 Agreement. Partly this seems to reflect the fact that such evidence meets the required test to prove damages for loss of bargain at common law as Briggs J observed:

> "where damages are sought for loss of bargain occasioned by the breach (leading to termination) of a commercial contract then, subject only to the availability of a market for the obtaining of a replacement contract, the cost of such a replacement contract as at the breach date is likely to prove the most reliable yardstick for measuring the loss of bargain."[9]

In making his determination that the firm quotation and replacement transaction should be used as the basis for the Close-out Amount calculation, Knowles J highlighted again what he considered to be the important distinction between commercial reasonableness under the 2002 Agreement and rationality under the 1992 Agreement. He observed that "with its Primary Determination and the expert evidence it adduced, NPC illustrated the type of outcome that a contracting party given the role of decision maker and limited only by a requirement of rationality might instead press for regardless of the fact of that actual replacement transaction".[10]

In reaching the decision, the judge made several other points which suggest that while there are clear differences between the interpretation of the two agreements the approach taken on litigation relating to the 2002 Agreement may not ultimately be very different to the approach taken on the 1992 Agreement.

TIMING

One important aspect of the *NPC* case was NPC's decision to test the market by obtaining indicative quotes before transacting a few days later. Given the wording in the 2002 Agreement permitting reliance on market data and indicative quotations, was it permissible for NPC to wait for the replacement to be executed or did it have to take the first price obtained regardless of whether it was firm or not?

In discussing the standard of reasonableness Knowles J observed that, even if the standard is objective, a benefit in any event accrues to the Determining Party "in terms of control of the decision-making process and particularly its speed" (para 78).

This is in line with the definition of Close-out Amount, which expressly applies a standard of commercial reasonableness to the question of timing:

> "each Close-out Amount will be determined as of the Early Termination Date or, if that would not be commercially reasonable as of the date or dates following the Early Termination Date as would be commercially reasonable".

There is however a second control on timing in s 6(d)(i) of the 2002 Agreement which requires that the calculations contemplated by s 6(e) must be made "on or as soon as reasonably practicable following the occurrence of an Early Termination Date". These words are similar to the 1992 Agreement which stipulates that "a party will determine its Loss as of the relevant Early Termination Date or, if that is not reasonably practicable, as soon as of the earliest date thereafter as is reasonably practicable". Richards J in the *Enasarco* case determined that these words do not refer to the first possible date but require "a consideration of all of the circumstances including those which are particular to the person required to act by that date". Notwithstanding this, a number of parties have tried to argue in the context of the 1992 Agreement that only in exceptional circumstances will a party be permitted to calculate Loss as of a date falling after the Early Termination Date and that the choice of calculation method will, in part, be determined by the date as of which it allows Loss to be calculated.

For the 2002 Agreement, the NPC judgment suggests that, for the moment at least, the wording in s 6(d)(i) is subject to the wording in the definition of Close-out Amount which allows the Determining Party to determine the timing of the calculation by reference to its own commercial interests. Even though in some circumstances this may mean that the 2002 Agreement is perhaps more favourable to the party making determinations than the 1992 Agreement, it is notable that in the context of NPC the attempt to rely on the earlier indicative quotations failed.

AMENDING AND REPLACING CALCULATION STATEMENTS

NPC's difficulties with using indicative quotations arose, at least in part, because it did not choose to rely on them until 2016, almost seven years after termination. In order to do so, it withdrew its original calculation statement and submitted a new one.

The judge made clear that, once a party has served its calculation statement, it is not entitled to withdraw it and serve an amended statement, even where the counterparty has made no payment in reliance on the original. The reasons for this finding included that, by serving a calculation statement, the

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Determining Party causes a debt obligation from one party to the other. This is a significant contractual event that cannot be reversed.

The judge added that if there is an error in the determination, it is for the court or tribunal chosen by the parties to declare that an error has been made and to state what the Close-out Amount would have been on a determination that was without error.

As a party to the contract, the Determining Party could, nevertheless, serve a revised calculation statement as evidence to inform the question of whether there had been an error, although the language the judge used left open whether a determining party could apply to the relevant tribunal of its own volition to correct a mistake in its determination or whether it would have to hope for a challenge from its counterparty.

CALCULATIONS BY THE COURT

Knowles J made clear that, where there has been no valid calculation under the 2002 Agreement or where it is challenged whether a commercially reasonable method was used or a commercially reasonable result achieved, the court retained the ability to make its own determination.

This approach has been adopted previously with regard to Market Quotation calculations under the 1992 Agreement. In *Lehman Brothers Finance SA v Sal Oppenheim JR* [2014] EWHC 2627 (Comm), rather than remit the decision back to the Determining Party, the court was prepared to determine the amount payable based on expert evidence provided by the Non-defaulting Party in the absence of a Market Quotation that satisfied the definition.

The courts have, however, reached a different conclusion when considering Loss calculations. While Knowles observed that "on my understanding the reference to a decision remaining that of the decision maker where rationality is involved, does not mean that the court is unable to decide what a rational decision by a decision maker who is a party to the contract would be", this appears to be at odds with his view that in cases of rationality, the decision remains with the Determining Party. The decisions on Loss under the 1992 Agreement also seem to indicate that the court is entitled to decide only what a rational decision would look like but not to replace the calculation with its own. In *Enasarco*, Loss was judged to have been correctly determined. In *Peregrine*, the approach taken was in line with that in *Wednesbury* itself. While the court ordered that Loss was to be determined as the claimant had contended and in accordance with the principles set out in the judgment, the decision was to be remitted back to the Determining Party who was to be confined by these factors.

YOU REALLY WANT TO BE THE DETERMINING PARTY

Although NPC failed to achieve the higher Close-out Amount specified in its Primary Determination, Lehman failed to show that its own valuation based on a model was correct or sufficiently robust to dislodge the replacement transaction.

Lehman's MTM (mark to market) valuations showing a large payment due to Lehman were not the same as the price at which a replacement could be achieved and the Close-out Amount was concerned with the losses or costs (or gains) in providing the Determining Party the economic equivalent of the material terms of the Terminated Transaction. All of the prices provided to NPC showed a payment due to the replacement counterparty.

The discounting curves used by Lehman's modellers to reflect the forward value of NPC's covenant to pay PHP were also criticised:

> "In the real world at this time, there were a number of examples (including the pricing of the options and the quotations) that no material value was forthcoming for the covenant of NPC in terms of the PHP cashflow."

While the judge does not give reasons for this statement, it appears to go some way towards acknowledging that credit quality should be taken into account at least in Close-out Amount calculations under the 2002 Agreement. This is consistent with the wording in Close-out Amount expressly acknowledging that quotations may take into account the creditworthiness of the Determining Party but perhaps more difficult to reconcile with the finding on the 1992 Agreement in the *Peregrine* case.

The difficulties that Lehman and others have faced using models to attack replacement transactions bring to mind the statement by Henderson that "there is a significant advantage to being the determining party … you really do want to be the determining party" which continues to be true of the 2002 Agreement as well as the 1992 Agreement in a wider sense than he originally envisaged.[11] ■

1 *Fondazione Enasarco v Lehman Brothers Finance S.A.* [2015] EWHC 1307 (Ch) at 53.
2 [2012] EWHC 1072 (Ch).
3 [2012] EWHC 1072 (Ch) at 82.
4 [2008] EWCA Civ 116.
5 [2008] EWCA Civ 116 at 66.
6 [2018] EWHC 487 (Comm) at 81.
7 [2018] EWHC 487 (Comm) at 86.
8 [2014] EWHC 2627 (Comm) at 16 (Market Quotation), [2015] EWHC 1307 (Ch) at 49.
9 *Anthracite Rated Investments Jersey Limited v Lehman Brothers Finance S.A* [2011] EWHC [1322] at 117.
10 [2018] EWHC 487 (Comm) at 95.
11 Henderson on Derivatives (2nd edition) 19.6, referring to the gap between bid/offer spreads.

Further Reading:

- *Enasarco v Lehman:* an important guide to the determination of Loss (2015) 7 JIBFL 428.
- *Socimer International Bank v Standard Bank* ten years on: the enduring lessons (2018) 2 JIBFL 87.
- LexisNexis Loan Ranger blog: Calculating close-out amounts under the 2002 ISDA Master Agreement (*Lehman Brothers Special Financing Inc v National Power Corporation and another*).