LMA Briefing Q2 2018

What is a reasonable opinion on "fair market value"?

In this briefing, Brian Cain, a consultant at LexisPSL Banking & Finance, looks at the case of *LBI EHF v Raiffeisen Bank International AG* [2018] EWCA Civ 719 in which the Court of Appeal gives guidance on the way in which a party should go about forming a reasonable opinion on the fair market value of an asset or liability. The case considers the provisions of the interpretation of 'fair market value' as it appears in the Global Master Repurchase Agreement (GMRA) which is the standard market documentation used in repo transactions. The Court of Appeal's guidance on this widely used documentation is welcome. Additionally, the judgment will be of wider interest to those who are parties to finance documents which require similar determinations to be made.

Facts

Landsbanki Islands hf. (**LBI**) and Raiffeisen Bank (**RBI**) entered into a series of repo transactions under which a portfolio of bonds had been provided as collateral for a loan.

LBI went into receivership in 2008 which was an Event of Default under the GMRA. This meant that RBI was entitled to claim from LBI a sum calculated as the agreed Repurchase Price for the securities less the Default Market Value of Equivalent Securities.

In arriving at the Default Market Value of Equivalent Securities RBI had to calculate the Net Value of the Equivalent Securities. Net Value is defined in the GMRA as:

*""Net Value" means at any time, in relation to any Deliverable Securities or Receivable Securities, 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 Equivalent Securities or Equivalent Margin Securities) as the non-Defaulting Party considers appropriate, less, in the case of Receivable Securities, or plus, in the case of Deliverable Securities, all Transaction Costs which would be incurred in connection with the purchase or sale of such Securities;"*

RBI as the non-Defaulting Party had to form a reasonable opinion of the fair market value of relevant securities under these terms to use in calculating the sum it was due from LBI.

The issues were similar in both courts – LBI losing at first instance.

LBI's arguments

LBI argued that the judge at first instance had:

- failed to give sufficient weight to the contractual context in which the words 'fair market value' appear;
- failed to have regard to, or to take sufficient account of, the Guidance Notes that accompany the GMRA as a permissible aid to the construction of 'fair market value'; and
- reached a commercially unsound conclusion contrary to the guidance promulgated by the publishers of the GMRA.

LBI in essence claimed that RBI had not correctly assessed fair market value. LBI considered both at first instance and in the Court of Appeal that the computation of a fair market value required RBI to make an assessment of the price from the perspective of an unimpaired/willing buyer and an unimpaired/willing seller, neither being under any particular compulsion to trade. It further argued that such an assessment should not reflect liquidity issues or distress that happen to feature in a particular market at a particular time such as the conditions that prevailed during October 2008 at the start of the global financial crisis.

LBI thought that a non-Defaulting Party which like RBI had either (a) been unable to sell the securities or (b) could not obtain commercially reasonable quotations, must in making the determination of "fair market value" use a methodology which was not reflective of then prevailing current market distress. RBI was required, argued LBI, to form a reasonable view of the intrinsic value of the bonds by a process of valuing them in accordance with a reasonable valuation model.

In support of this contention LBI argued that "fair market value" was used in numerous widely used commercial contexts apart from the GMRA in a sense consistent with the willing seller/willing buyer concept and that these other examples of the use of that term had been ignored by the judge. The use of "fair" in the term LBI stated meant the assessment to be made by RBI must leave out of account thin trading or panic in the market and take no account of illiquidity and distress.

RBI's arguments

RBI argued that the words *"in the reasonable opinion of the non-Defaulting Party, represents their fair market value"* conferred upon it a very wide discretion. RBI could have regard to such pricing sources and methods as it considered appropriate in determining what, in its reasonable opinion, constituted the 'fair market value' of the securities. The only constraint on this wide discretion was that RBI as the non-Defaulting Party had to act rationally and not arbitrarily or perversely. To uphold LBI's argument would impose a significant restriction as a matter of law on the wide discretion conferred on RBI by the provision.

Decision

The Court of Appeal found no reason to imply any restrictions into the GMRA to qualify the wide discretion conferred on RBI by its terms. The only limitation affecting RBI's discretion under the repo contracts was the one recognised by the court in the earlier cases of *Socimer Bank Ltd v Standard Bank Ltd* [2008] EWCA Civ 116 and *Lehman Brothers International (Europe) v Exxonmobil Financial Services BV* [2016] EWHC 2699 (Comm) that the decision-maker must act rationally and not arbitrarily or perversely.

The Court of Appeal did not agree that there was a requirement to ignore the prevailing distressed market conditions and substitute the fiction of a normally operating securities market during a global financial crisis. Such a construction of the GMRA would make no commercial sense.

The Court of Appeal cited its earlier decision in *Barclays Bank plc v Unicredit Bank AG* [2014] EWCA Civ 302 for the view that the phrase had to be construed in this particular contract and in the proper context of the market in which the parties were operating. For example, it was highly significant that the GMRA provided that RBI could have regard to whatever "pricing sources and methods" and to "available prices for Securities" as it considered appropriate. There was no limitation in the wording of the provision as to the factual circumstances in which RBI as the non-Defaulting Party can have regard to those matters.

Finally, the Court of Appeal decided that some of the information published by ICMA in support of the GMRA such as its FAQs was of no assistance in the proper construction of the contract between the parties. These documents were clearly marked as being for "information" only and were not to be used as aids in construction.

In conclusion

The Court of Appeal decision is to be welcomed. LBI was surely straining the terms of the GMRA's definition of Net Value to breaking point in arguing that it imposed an obligation upon the non Defaulting Party to ignore actual market conditions and substitute some unspecified ideal market conditions – particularly in the aftermath of the collapse of Lehman Brothers. Imposing such an obligation upon a counterparty would require clear words.

The decision in *LBI* is the latest in an expanding line of cases where the courts, whilst insisting upon rationality by the relevant determination maker, are unwilling to impose artificial or unnecessarily complex restraints upon those called upon to form reasonable opinions in making determinations under contract terms that contain a discretionary element.