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Determining Fair Market Value upon Default

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Executive Summary

The Court of Appeal's decision of 11 April 2018 in LBI EHF v Raiffeisen Bank International AG[1] considered the scope of a non-Defaulting Party's discretion in ascribing a "fair market value" to securities pursuant to the close-out mechanics of the industry standard Global Master Repurchase Agreement (2000 version) (the "GMRA")[2].

The Court held that the non-Defaulting Party has, pursuant to the express terms of the relevant GMRA provisions, wide discretion to determine the "fair market value" of the securities; and that as a matter of principle the only limitation on that discretion that will be recognised is that the non-Defaulting Party must have acted rationally[3] and not arbitrarily or perversely.

Summary of the Facts

The respondent bank, Raiffeisen Bank International AG ("RBI"), had eleven open positions under the GMRA with the appellant bank, formerly known as Landsbanki Islands hf ("LBI"), when LBI went into receivership on 7 October 2008.

Under these repurchase (repo) transactions, RBI was the Buyer and LBI was the Seller, so that: (i) on the Purchase Date LBI transferred the Purchased Securities to RBI and RBI paid the Purchase Price, and (ii) on the Repurchase Date, RBI would transfer Equivalent Securities to LBI and LBI would pay the Repurchase Price. (The repos operated, commercially but not legally, as a form of collateralised lending transaction, with LBI as the borrower.)

The receivership of LBI, together with LBI's statement that it was "unable to make any payments" following receipt of a margin call, constituted an Event of Default under paragraph 10 of the GMRA. RBI then served Default Notices on LBI the next day[4], whereupon the close-out mechanics of the GMRA applied, a brief overview of which is as follows:

- the Repurchase Date (broadly, the 'end date' of the transaction when securities are due to be redelivered) for each Transaction is deemed to occur immediately and all Cash Margin and Equivalent Margin Securities are immediately payable / deliverable (paragraph 10(b) of the GMRA);
- the non-Defaulting Party establishes as at the Repurchase Date:
  - the Default Market Values (broadly, the market value) of the Equivalent Securities and Equivalent Margin Securities (in other words, the obligation to redeliver securities is replaced by an obligation to pay their Default Market Value);
  - the amount of Cash Margin to be transferred; and
  - the Repurchase Prices (paragraph 10(c)(i) of the GMRA);
- on the basis of the above, the non-Defaulting Party determines amounts due from one party to the other. Such sums are then set off against each other, leaving a single net sum to be paid on the next day. In this particular case, LBI was required to pay RBI the

Repurchase Price less the Default Market Value of Equivalent Securities (paragraph 10(c)(ii) of the GMRA).

Paragraph 10(e) of the GMRA is the operative provision setting out how the Default Market Value of (inter alia) Equivalent Securities is determined. The result will vary depending on whether a Default Valuation Notice has been served by the non-Defaulting Party on the Defaulting Party by the end of the fifth dealing day after the date of the Event of Default (i.e. the Default Valuation Time, which in this case was 15 October 2008). If a Default Valuation Notice has been so served, then the Court summarised the three valuation methods under paragraph 10(e)(i) of the GMRA as follows:

- the securities held by the Buyer (i.e. the Purchased Securities, which act as collateral under the transaction) can be sold in good faith and the sale price used to determine the Default Market Value;
- the Default Market Value can be determined from the mean average of commercially reasonable quotations obtained from market makers for the securities;
- where the non-Defaulting Party has endeavoured but has been unable to sell the securities or cannot obtain commercially reasonable quotations, the non-Defaulting Party can determine the Net Value (see below) of Equivalent Securities and elect to treat that Net Value as the Default Market Value.

Where a Default Valuation Notice has not been served by the non-Defaulting Party on the Defaulting Party by the Default Valuation Time, then paragraph 10(e)(ii) of the GMRA provides that the Default Market Value of Equivalent Securities will be "an amount equal to their Net Value at the Default Valuation Time". This is subject to the non-Defaulting Party being able to postpone the Default Valuation Time for this purpose where it reasonably determines that owing to circumstances affecting the market it is not possible for it to determine a Net Value which is commercially reasonable at that time.

RBI did not serve a Default Valuation Notice within the five day window prior to the Default Valuation Time, in which case paragraph 10(e)(ii) of the GMRA applied (the proviso at the end – around the non-Defaulting Party being able to postpone the Default Valuation Time – did not). Therefore, in order to value the Equivalent Securities, RBI needed to calculate the Net Value as at 15 October 2008. "Net Value" is defined in the GMRA as follows (we have emphasised relevant wording in bold):

""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;".

LBI disputed the "Net Value" determination of RBI (derived from bids from ten institutional counterparties, algorithm-based prices shown on Bloomberg and activity experienced by RBI at the Default Valuation Time) on the basis that they had not obtained a fair market value given that the prices were achieved in a distressed market.

The crux of the issue at hand was set out at paragraph 7 of the Court of Appeal judgment, where Lord Justice Flaux stated that: "… the principal issue the judge had to decide was the meaning of "fair market value" as that phrase was used in the GMRA".

First Instance Judgment

In the original judgment, the judge, Mr Justice Knowles, rejected the following submissions made by LBI:

- That "fair market value" should be informed by the way that those words have been used in other legal and financial contexts (e.g. International Financial Reporting Standards). He stated that he did not "… consider it a reliable approach to take definitions offered by those sources when the words appear without those definitions in the GMRA"; and
- That on the basis of other definitions of "fair market value", that phrase should be limited to a consistently recognised concept associated with fair market value involving a willing buyer, willing seller, knowledge of the asset in question and a lack of compulsion. He stated that he did not "… consider the words are to be limited in this way…" and that such an interpretation would be incompatible with the fact that under paragraph 10(e)(i) of the GMRA securities may be sold in a distressed market and the Default Market Value determined accordingly, provided that the non-Defaulting Party acts in good faith.

Instead, Mr Justice Knowles referred to the "reasonable opinion of the non-Defaulting Party" language in the definition of Net Value and stated that "… the task for the Court was to put itself into the shoes of the decision maker" and ask what decision "… it would have reached, acting rationally and not arbitrarily or perversely". In other words, given the drafting of the definition, the non-Defaulting Party had a broad discretion in how to make the determination provided that it acted within the bounds of rationality.

Having considered the figures submitted by RBI in relation to the determination of the Net Value, Mr Justice Knowles held that the requirement for a rational and honest determination of fair market value as at 15 October 2008 was met. He stated that: "There is no doubt that the information available in the present case was imperfect … However the circumstances at that time were imperfect. Any assessment of fair market value would have been imperfect but the non-Defaulting party was nonetheless entitled to make one".

Grounds of Appeal

Permission to appeal was granted only in respect of Mr Justice Knowles' finding that on the true construction of the GMRA, the non-Defaulting Party's assessment of "fair market value" of securities could be based on prices achieved or quotations obtained in a distressed or illiquid market.

Appeal Decision

The Court of Appeal dismissed the appeal, addressing first the definition of "Net Value" itself. Noting that the language of the definition gave the non-Defaulting Party wide discretion to assess fair market value by reference to "such pricing sources and methods … as the non-Defaulting Party considered appropriate…", it stated that "in the absence of some express or implied limitation in the contract on the exercise of the discretion, as a matter of principle, the only limitation will be … that the decision-maker must have acted rationally and not arbitrarily or perversely".

The Court found that there was no express term of the GMRA to support LBI's contention that the assessment of fair market value must be by reference to a price agreed between an unimpaired/willing buyer and an unimpaired/willing seller, neither being under any particular compulsion to trade, so that any illiquidity or distress in the market is left out of account; and nor was there any basis to imply such a caveat since to do so would be contrary to the express language, in particular the wide discretion given to the non-Defaulting Party. As Lord Justice Flaux stated, there was "… no warrant for limiting the width of the discretion provided by the contract wording by requiring the non-Defaulting Party to disregard the evidence of the market merely because it was illiquid or distressed at the particular time".

The Court also declined to precisely define the meaning of 'fair market value', instead noting that it must be determined as a matter of

construction of a particular contract in a particular context.

AB Trading Advisors View and Comment

Confirmation of Broad Discretion

Context is everything. On examining the express language of the definition of "Net Value", the Court found that there was no scope for limiting the very broad discretion afforded to the non-Defaulting Party in determining the fair market value beyond an obligation to make the determination rationally. This is now the second case to consider matters of fair market value valuations under the GMRA[5] and both have reached the same conclusion.

Status of Guidance and FAQs

Many industry trade bodies publish guidance or Frequently Asked Questions (FAQs) in relation to industry standard documentation. The Court considered the guidance notes accompanying the GMRA and the FAQs on Repo published by International Capital Market Association (ICMA), but noted that, given that the FAQs stated that they were "for information only", they were almost certainly not admissible as an aid to construction of the contract.

2011 Version of the GMRA

As a point to note, the latest version of the GMRA, the 2011 version, no longer includes the concept of a Default Valuation Time or Default Valuation Notice. Instead, the non-Defaulting Party must determine the Default Market Value "on or as soon as reasonably practicable after the Early Termination Date" with no requirement to serve a Default Valuation Notice.

Contrasting Early Termination Payments under the ISDA Master Agreement: Rationality vs Reasonableness

The ISDA Master Agreement also contains close-out mechanics which confer discretion on the non-defaulting party when making its determinations pursuant to the default close-out mechanics. In the case of: (i) the ISDA 1992 Master Agreement, one measure of payment (if elected) is "Loss" (essentially, an amount a party reasonably determines in good faith to be its total losses and costs or gains in connection with the agreement or the terminated transaction); and (ii) the ISDA 2002 ISDA Master Agreement, the amount payable will be the "Close-out Amount" (essentially the amount of losses or costs or gains that are or would be incurred / realised under prevailing circumstances determined in good faith and using commercially reasonable procedures in order to produce a commercially reasonable result).

In Fondazione Enasarco v Lehman Brothers Finance SA[6], it was held that in considering whether a non-defaulting party had reasonably determined its Loss all that was required was that the party must not arrive at a determination which no reasonable non-defaulting party could come to. There is no objective standard of care, but rather "it is essentially a test of irrationality…". Therefore, the standard for the calculation of Loss is one of rationality or of Wednesbury unreasonableness[7] – thus narrowing the scope of any potential challenge to the determination of the non-defaulting party.

However, in a more recent case, Lehman Brothers Special Financing Inc. v (1) National Power Corporation; (2) Power Sector Assets and Liabilities Management Corp[8], and in contrast to the subjective rationality standard of the calculation of Loss, it was held that the determination of a Close-out Amount requires procedures "… that are, objectively, commercially reasonable in order to produce,

objectively, a commercially reasonable result". The Court also doubted if the Close-out Amount calculation afforded the determining party a discretion in respect of such calculation.

Therefore, a higher standard is involved in determining a Close-out Amount (an objectively reasonable commercial standard – which is not simply acting rationally) compared to determining Loss (it must not be irrational). As stated in Hayes v Willoughby[9]: "Rationality is not the same as reasonableness. Reasonableness is an external, objective standard applied to the outcome of a person's thoughts or intentions. … A test of rationality, by comparison, applies a minimum objective standard to the relevant person's mental processes…".

In terms of general contract drafting, a cautionary note was struck in National Power when the judge stated that "… if the contracting parties want objective criteria of reasonableness to apply, they may need to do more than just use the word "reasonable"".

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[1] [2018] EWCA Civ 719; available at: http://www.bailii.org/ew/cases/EWCA/Civ/2018/719.html

[2] See https://www.icmagroup.org/assets/documents/GMRA2000.pdf. For ease, capitalised terms in this Briefs for the Buy side which are not defined shall have the meaning ascribed to them in the GMRA.

[3] See also AB Trading Advisors View and Comment – Contrasting Early Termination Payments under the ISDA Master Agreement: Rationality vs Reasonableness below.

[4] As an aside, the Default Notices were sent by fax and the judge at first instance (Mr Justice Knowles: the judgment is available at: http://www.bailii.org/ew/cases/EWHC/Comm/2017/522.html) decided that for the purposes of paragraph 14 of the GMRA, receipt by a 'responsible employee of the recipient' does not require the employee to be someone who will appreciate what the notice is and what it signifies.

[5]Lehman Brothers International (Europe) v Exxonmobil Financial Services BV [2016] EWCA Civ 116 is the other.

[6] [2015] EWHC 1307 (Ch).

[7]Wednesbury unreasonableness means that something is so unreasonable that no reasonable person acting reasonably could have made it (Associated Provincial Picture Houses Ltd v Wednesbury Corporation (1948) 1 KB 223).

[8] [2018] EWHC] 487 (Comm); available at: http://www.bailii.org/ew/cases/EWHC/Comm/2018/487.html ("National Power").

[9] [2013] UKSC 17 (Cited by Mr Justice Knowles in National Power.)
