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August 2014

Market quotations: indicative or firm?

Contents

Until recently, case law on the ISDA Master Agreement's close-out provisions has been scarce—presenting challenges to lawyers who have had to grapple with these complex terms. However, the litigation that has followed in the wake of the global financial crisis has seen a number of Master Agreement disputes reaching the courts. Although many uncertainties remain, the mysteries of the Market Quotation, Loss and Close-out Amount provisions are therefore slowly being unlocked.

The facts

The latest case, *Lehman Brothers Finance SA v Sal Oppenheim Jr & Cie KGAA* [2014] EWHC 2627 (Comm), concerned a 1992 ISDA Master Agreement that had been entered into between Lehman Brothers Finance SA ("**LBF**") and Sal Oppenheim Jr & Cie KGAA ("**Oppenheim**"). The Agreement terminated automatically when the Lehman Brothers group collapsed and, as the Non-defaulting Party, Oppenheim was required to determine the close-out amount that became due as a result. Despite the fact that Market Quotation had been selected, however, it transpired that no quotations had been sought. Instead, Oppenheim had made its determination using market values prevailing at the close of business on the business day *before* the termination took place, even though the Agreement required it to seek quotations "*on or as soon as reasonably practicable after the Early Termination Date*".

Against that background, it is hardly surprising that LBF sought to challenge the determination, or that it succeeded in doing so. What is interesting about the case, however, is that it establishes a number of principles that are of much wider application.

Firm quotations

Foremost amongst these is that, where Market Quotation applies, any quotations must be "firm", rather than "indicative", i.e. they must be ones "*capable of being taken up there and then*". The historic valuations used by Oppenheim could not be said to be "quotations" because there was no possibility of trading on the basis of them. Although the market was closed on the Early Termination Date, that did not justify the use of the previous day's figures: quotations should instead have been sought on the following day, when the market reopened. It follows that, where quotations are sought after the Early Termination Date, the enquiry is not about the price at which a replacement transaction *could have been entered into* on the Early Termination Date. The price to be quoted is the amount that will be payable if the quotation is accepted (albeit that the *term* of the transaction must be backdated so as to start on the Early Termination Date). The quotation will therefore reflect the market value of the transaction at the time it is provided.

Impact of market movements

Oppenheim sought to justify its approach by pointing out that the market movements occurring around the Early Termination Date were at least partly caused by the insolvency of LBF's holding company, which was an Event of Default under the Master Agreement. When calculating any close-out amount, it has to be assumed (amongst other things) that no Event of Default exists. This, argued Oppenheim, means that any impact on the market of the Event of Default must also be disregarded. This argument was decisively rejected. Quite apart from the fact that the previous day's price is not necessarily the price that would have prevailed but for the Event of Default (so that it would be a matter of speculation what that price would have been), such a conclusion would make no commercial sense. Whether the market goes up or down after the Early Termination Date, the Non-defaulting Party must pay, or is entitled to receive, a sum that represents the price of a replacement transaction on, or as soon as reasonably practicable after, that date. In either case, it is made whole.

The fall-back to Loss

Oppenheim also pointed out that a Non-defaulting Party is not required to use the Market Quotation methodology if a Market Quotation cannot be determined or, in its reasonable belief, would not produce a commercially reasonable result. In these circumstances, the Loss methodology applies instead, which gives the Non-defaulting Party a wider discretion to decide how to determine the close-out amount. By the time the market reopened, Oppenheim had hedged its positions and so did not need to enter into replacement transactions. It therefore argued that it was entitled to use Loss in substitution for Market Quotation.

This argument was also rejected. It was clear that a Market Quotation *could* have been determined, albeit by waiting until the day after the Early Termination Date to obtain the necessary quotations. The question, therefore, was whether Oppenheim could rationally have believed that this would not have produced a commercially reasonable result. In fact there was no evidence that Oppenheim had formed such a belief, or that it had directed its mind to the question at all. Even if it had done so, the fact that it was reasonable to hedge its exposure otherwise than by entering into replacement transactions did not mean that the use of the Market Quotation methodology was *unreasonable*. It would have been irrational to have concluded otherwise and so any determination it might have made to this effect could have been challenged. This shows that the fall-back to Loss cannot be used retrospectively to justify a failure to follow the Market Quotation procedure properly, on the basis that it would not have produced a commercially reasonable result anyway: the Non-defaulting Party must have reached such a conclusion at the time it makes its determination.

The Court's reasoning also throws some light on the operation of the Loss methodology. Like Market Quotation, this requires the close-out amount to be determined as of the Early Termination Date "*or, if that is not reasonably practicable, as of the earliest date thereafter as is reasonably practicable*". It follows that the use of quotations, or market values, from a time prior to the Early Termination Date is not permissible, even if the market is closed on the Early Termination Date. Indeed, the same is true under the 2002 ISDA Master Agreement. Although that expressly permits the use of indicative quotations, any quotations that are used must represent the position on the Early Termination Date, or as soon as is commercially reasonable thereafter.

Implications

Although nothing in this judgment should come as a surprise, it is far from true that the procedure required by the ISDA Master Agreement is universally followed. In many instances, dealers who are asked for quotations expressly state that the quotations are provided for valuation purposes only, or that trading is subject to internal approval. It is now clear that these do not qualify as quotations under the Market Quotation provision, which will often mean that Loss must be used instead. This, in turn, gives rise to further issues, including the extent to which it is reasonable to use indicative quotations in that context and whether the Non-defaulting Party ought to mitigate its loss by using the most favourable quotation available. These are questions that have yet to be fully examined by the Courts.

Furthermore, parties requesting quotations often state that they are doing so in order to value a transaction, so that they do not intend to trade on the basis of them. Where this is done and firm quotations are not provided, the Market Quotation methodology will not have been properly followed. The Defaulting Party will therefore be entitled to challenge the Non-defaulting Party's determination if it can show that a sufficient number of firm quotations would have been provided if they had been requested. There will be no fall-back to Loss in such a case: the Court will simply do its best to work out what the result would have been if the Market Quotation procedure had been properly followed. Given the frequency with which errors of this nature are made, Oppenheim is unlikely to be alone in facing such a remedy.

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