The world of derivatives is replete with disputes. The contingent nature of these contracts means investors frequently disagree about the amounts owed. Pottery Research, in this brief note, explores some of the difficult substantive questions that the English courts have recently had to deal with. This should give practitioners in this area a stronger idea of how to manage situations in which a derivative trade must be closed out.

The Derivatives Market

Size and Systemic Risk

The OTC derivatives market is significant in terms of its trading volume and collateralized exposure. Notional amounts outstanding for OTC derivatives exceeded $542 trillion at end-June 2017 according to the Bank for International Settlements. With respect to collateralization, the ISDA Margin Survey 2017 finds that approximately $1.41 trillion of collateral has been posted by market participants with the 20 largest market participants for non-cleared derivatives. This is the size of the derivatives market which derivatives disputes apply to. Therefore, the important point is that any dispute as to participants’ use of standardised financial contracts such as the ISDA Master Agreement could result in systemic risk issues.

This is why the Lehman Brothers litigation is so closely followed. Any dispute as to the use of standardised financial contracts such as the ISDA Master Agreement could result in contract failure across other financial market contracts. This is what necessitates analysis of legal uncertainty. The Lehman Brothers Special Financing Inc. v. (1) National Power Corp; (2) Power Sector Assets and Liabilities Management Corp. [2018] EWHC 487 (Comm) case is the latest in this world of complexity.

Significance of Lehman Disputes

Consistency and Billions

The Lehman Brothers case is particularly important for two obvious reasons. Firstly, it emanates from the Lehman Bankruptcy and contributes to a long line of cases (over 30+) addressing difficult issues arising from the largest insolvency dealt with by the English courts. Secondly, it contributes to the wider market understanding of how standard form contracts in the derivatives market work. This is immensely important, considering that most of these provisions have never been disputed before. When you have a contract that governs billions of dollars, it is generally difficult to be keen to litigate. In many cases, the differences in opinion should probably be worked out over a phone call.
Closing out a derivative
Termination, valuation and netting

Close out netting is one of the most important aspects of a derivative contract. In an ISDA Research Note (2010) on “The Importance of Close of Netting”, The International Swaps and Derivatives Association (ISDA) refers to it as a process involving termination of obligations under contracts with a defaulting party and subsequently combining positive and negative replacement values into a single sum which is payable on a net basis.

Participants in the derivatives market agree to close out netting principles in their private agreements. The most popular of which is the ISDA Master Agreement (1992-2002). The ISDA introduces the concept of close out netting. As per process, close out netting involves the termination, valuation, and netting out of contractual obligations upon the occurrence of certain events. These are 1) Events of Default and 2) Termination Events. In the Lehman Brothers example, the “event” was one of insolvency, which would have triggered the close out netting obligations. Following the occurrence of these events, a party is entitled to terminate the agreed transactions covered by the ISDA.

Lehman Brothers Special Financing Inc v National Power Corp (EWCH 487 (Comm))

A USD/Philippine Peso Forward

The transaction was a USD 100 million USD/Philippine Peso forward current swap. It was entered into in 2007 between LBSF and NPC. NPC was owned by the Republic of the Philippines. As readers will know, the Lehman entity (LBSF) went bankrupt in September 2008. Under the swap contract, this is constituted as an event of default, thereby entitling NPC to serve notice that 3 November 2008 would be an Early Termination Date for the purposes of the Master Agreement, at which stage obligations under the contract are extinguished and payments are made.

NPC wanted to reinstate the hedging transaction it had just lost with LBSF (due to its bankruptcy). It went to the market and solicited bids for a replacement hedge. NPC eventually entered into a replacement transaction with UBS on 7 November 2008, a day before its transaction with Lehman would end.

Before the above process takes place, the Lehman entity had to provide a calculation of the position of each party (i.e who owes who what). This calculation statement showed NPC to be substantially out of the money. However, the effect of the quotations for replacement transactions which NPC received in November 2008 was that a replacement transaction would be substantially more expensive, compared to the original swap.

Method for closing out the trade
Debating “good faith”

On this basis, the swap contract (reflected in the ISDA Master Agreement) provided that as the non-defaulting party, NPC was to determine the Close-Out Amount payable “in good faith” and using “commercially reasonable procedures in order to produce a commercially reasonable result”. NPC accordingly served a calculation statement demanding USD 3.46 million from LBSF. This represented the additional cost of entering into the replacement transaction with UBS.

All seemed to be going well for NPC. Not until LBSF objected that commercially reasonable procedures were not used to arrive at the USD 3.46 million figure and that it was not a commercially reasonable result. LBSF also pointed out that the transaction with UBS was a bargain for NPC and that “bargain” so to speak, was not reflected in the price of the transaction. This later transaction contained an option.
Investing in Nigeria

Investment Aid Agencies:
• Nigerian Investment Promotion Commission.
• Economic Developments and Prospects in Nigeria – African Economic Outlook.
• Nigerian Export Promotion Council
• Nigerian Export Processing Zones Authority

Public Private Partnerships:
• African Development Bank Group, Public Oversight Body.
• DG Market.

“Traders are not allowed to simply produce what is reasonable. They are required to go through well thought out processes to determine values.”
On the above basis, LBSF sued. It argued that the correct Close-out Amount was USD 12.8 million. NPC disagreed. They served a revised calculation in 2016 containing not one but two alternative calculations. The first was based on indicative quotations provided by UBS giving rise to a Close-out Amount of USD 10.7 million payable to NPC. The second calculation started from the calculation set out in the initial calculation statement but accrued amounts were deducted.

**The decision**

**Objective reasonableness**

In a reasoned judgement, it was decided that the words of the contract require objective reasonableness. In simple English, this means the non-defaulting party (in this case – NPC) must be very exact in its calculation of a Close Out Amount. This is especially the case if the derivative trade is under the 2002 ISDA Master Agreement. Traders are not allowed to simply produce what is reasonable. They are now required to go through well thought out processes to determine values. This includes adequately deducting the accrued amounts when reaching the Close Out amount, something NPC failed to do. Nonetheless, LBSF’s claim failed. The appropriate Close-out Amount was approximately USD 2.14 million, which NPC was owed.