

English High Court determines meaning of Close-Out provisions of 2002 ISDA Master Agreement

12/03/2018 (*Commercial*)

Lehman Brothers Special Financing Inc. v. (1) National Power Corp; (2) Power Sector Assets and Liabilities Management Corp. [2018] EWHC 487 (Comm)

On 12 March 2018, Knowles J, sitting in the English High Court, Financial List, handed down an important judgment concerning the interpretation of the 2002 Version of the ISDA Master Agreement (“**2002 ISDA Master Agreement**”).

The judgment is the most detailed consideration to-date by the courts in England or New York of the Close-Out provisions of the 2002 ISDA Master Agreement. Despite the 2002 ISDA Master Agreement being in wide usage in financial markets globally, those provisions (unlike their equivalents in the 1992 ISDA Master Agreement) had not previously been the subject of detailed judicial consideration.

The case is the latest to arise from the collapse of Lehman Brothers in 2008, and concerned a USD 100 million principal-only USD/Philippine Peso forward current swap (“**Swap**”) entered into in 2007 between the Claimant (“**LBSF**”) and the First Defendant (“**NPC**”) and subsequently transferred to NPC’s successor, the Second Defendant (“**PSALM**”), both defendants being owned and controlled by the Republic of the Philippines. The bankruptcy of LBSF and its credit support provider in September 2008 constituted events of default, and NPC served notice that 3 November 2008 would be an Early Termination Date for the purposes of the Master Agreement.

NPC, wishing to reinstate the currency hedge which it had lost, solicited bids for replacement transactions from a number of banks, and eventually entered into a replacement transaction with UBS (“**UBS Transaction**”) based upon a firm quotation received on 7 November 2008. Although mark-to-market calculations produced by LBSF shortly before its bankruptcy showed the Swap to be substantially out of the money for NPC, the effect of the quotations for replacement transactions which NPC received in November 2008 was that a replacement transaction would be substantially more expensive for NPC than the original Swap had been.

The Master Agreement provided that as Non-defaulting Party it was for NPC to determine the Close-Out Amount payable “*in good faith*” and using “*commercially reasonable procedures in order to produce a commercially reasonable result*”. The equivalent wording used in the

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1992 ISDA Master Agreement was “*reasonably determines in good faith*”, which a succession of cases had held to impose a requirement of rationality and not objective reasonableness.

In January 2009 NPC served a calculation statement on LBSF demanding USD 3.46 million, representing the additional cost to it of entering into the UBS Transaction. LBSF contended that commercially reasonable procedures were not used to arrive at that figure and that it was not a commercially reasonable result, relying on a number of arguments, and, in particular, the fact that the UBS Transaction included an option which LBSF contended was valuable but was not reflected in the pricing of that transaction. In 2015 LBSF commenced a claim in the Commercial Court seeking payment of a substantial sum from the Defendants under the Swap. Blair J transferred the claim to the Financial List due to the significant importance to the market of the case. LBSF eventually contended, relying on a modelled calculation, that the correct Close-out Amount was USD 12.8 million payable to LBSF. In response, NPC served a revised calculation statement in 2016 containing two alternative calculations, one based upon an indicative (rather than firm) quotation provided by UBS on the Early Termination Date (several days before the UBS Transaction was entered into) which gave rise to a Close-out Amount of USD 10.7 million payable to NPC, and the other starting from the calculation set out in the initial calculation statement but deducting certain accrued amounts which it was admitted ought to have been but were not taken into account when serving the initial calculation statement in 2009.

The principal question of law before the Court was whether the requirement to use commercially reasonable procedures in order to produce a commercially reasonable result imposed only a rationality standard on the Non-defaulting Party in the exercise of its contractual right to determine the Close-out Amount, or whether it required the Non-defaulting Party to use procedures and achieve a result, which were objectively reasonable. Knowles J concluded that the words of 2002 Master Agreement required objective reasonableness. The effect of this significant decision is that the determining party will be subject to a more demanding standard where the transaction being closed-out is documented under the 2002 ISDA Master Agreement rather than the 1992 ISDA Master Agreement.

Knowles J also concluded that NPC had not been entitled to serve the revised calculation statements in 2016; however, the Judge concluded that NPC had been entitled to rely upon the UBS Transaction (as it had done initially) in determining the Close-out Amount, subject only to deducting the accrued amounts which it was common ground ought to have been deducted. LBSF’s claim therefore failed, and the Court held that the appropriate Close-out Amount was a sum payable to NPC of approximately USD 2.14 million.

In concluding his judgment Knowles J noted:

“If contracting parties want entirely objective criteria of reasonableness to apply, they may need to do more than just use the word “reasonable”. If they are content with rationality they need to understand that, even though they use the word “reasonable” they are not providing for the application of entirely objective criteria of reasonableness, and the result may be different accordingly.”

The full judgment is [here](#).

Jasbir Dhillon QC and Geoffrey Kuehne appeared for the successful defendants, instructed by Pinsent Masons LLP.

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