Unwinding derivative instruments without notice, in a private wealth context – what to consider

In *Tan Poh Leng Stanley v UBS AG* [2016] SGHC 17, the Singapore High Court considered how the various agreements which govern the relationship between banks and their private clients interact with each other. The case is important as it discusses the interpretation of ISDA Master Agreements against the lattice of agreements made in a private wealth context. The Court also considered the circumstances in which banks can unwind transactions without notice and the duty of care required when doing so.

Material facts of the case

The plaintiff, Stanley Tan Poh Leng (ST) invested in a number of equity accumulators[1] on a margin trading basis with UBS AG (the Bank) under a 1992 ISDA Master Agreement.

During the 2008 financial crisis, ST failed to satisfy a margin call from the Bank to post additional collateral so the Bank closed out ST's position, unwinding the accumulators which ST had invested in (the Accumulators) and selling the shares given as collateral.

ST challenged the Bank's right to unwind the Accumulators without issuing a notice as required under the ISDA Master Agreement.

In its judgment, the Court found that there was a superseding oral agreement between the parties to unwind the Accumulators.

As a result, there was no need to consider whether notice was required, because ST had consented to the unwinding.

However, the Court also considered in detail, on an *obiter* basis, issues of incorporation and interpretation which arose in the context of the ISDA Master Agreement and the other agreements between ST and the Bank.

It is the substance of the Court's *obiter* comments that is of particular interest.

Hierarchy of agreements

There were four principal agreements between the parties which formed the basis of their legal relationship. These were:

1. the account agreement (Account Agreement) through which ST opened his wealth management account with the Bank;
2. the Credit Services Notification Letter (CSNL) through which ST accepted the Bank's credit facilities for margin trading, and which contained a clause which gave the Bank the right to unwind

Key issues

- The wider commercial relationship is highly significant in determining the scope of "without notice" termination rights between parties.
- Banks should be mindful, in private wealth transactions, of the termination provisions in account mandate and credit relationship agreements.
- The Court held that the Bank's unwinding of the transactions, based on the VWAP method was not unreasonable, and did not amount to a breach of its duty of care to the customer.

[1] An accumulator is a structured product in which an investor agrees to buy, periodically, a fixed quantity of shares at a fixed price for a predetermined period of time.

the Accumulators without notice (the Without Notice Clause);

3. the ISDA Master Agreements (the ISDAs) entered into in 2006 and 2008, which outlined the terms that would apply to derivatives transactions between ST and the Bank (such as the Accumulators). In particular, s 6(a) of the ISDAs prescribed a certain period of notice that had to be given before the accumulators could be unwound; and
4. the confirmations issued for each of the Accumulators entered into between ST and the Bank (the Confirmations).

The Court, in its analysis of the relationship between the agreements, attached particular importance to s 1(b) of the ISDAs, which provided that, in the event of conflict between the provisions of any Confirmation and the applicable ISDA, the terms of the Confirmation would prevail. The Court held that if the Confirmations either incorporated or explicitly gave to the Bank the right to unwind without notice, the Bank would have such a right regardless of the terms of the applicable ISDA.

It is trite law that parties can establish between them a hierarchy of agreements for the purposes of resolving issues of inter-contractual interpretation. The equally obvious, yet crucial, knock-on effect is that it becomes essential to set out precisely which terms have been incorporated into the agreement that is higher in the hierarchy.

What terms are incorporated

The Court, citing the Court of Appeal's decision in *International Research Corp PLC v Lufthansa Systems Asia Pacific Pte Ltd and another* [2014] 1 SLR 130, held that the Confirmations incorporated the Without Notice Clause in the CSNL.

In deciding whether the Without Notice Clause had been incorporated into the Confirmations, the Court based its conclusion on a number of factors.

First, it found "*significant overlap*" between the obligations of ST in the CSNL and the Confirmations – both agreements required ST to provide collateral to support the Accumulators.

Secondly, the agreements explicitly cross-referenced each other.

Thirdly, the Court held that it made "*absolutely no commercial sense*" for the parties to incorporate the obligation to provide collateral without incorporating the corresponding right of termination.

Finally, the Court took into account the larger commercial relationship between the parties. ST and the Bank were not merely derivatives counterparties; there concurrently existed between them a lender-borrower relationship. It was therefore apparent that the overarching intention of the parties was to extend the rights of the Bank in the CSNL (as a lender) to the Accumulators.

The factors considered by the Court demonstrate that incorporation and interpretation are essentially one **single** exercise. The Court must determine what the parties meant by the language used (hence the reference to the overlap and cross-referencing between the agreements); and this involves ascertaining what a reasonable person, with all the background knowledge that is available to the parties (hence the considerations of commercial sense and the relationship between the parties), would have understood the parties to have meant.

Whether the incorporated terms and the ISDAs are inconsistent

In view of the above, the Court made clear that where any inconsistency existed between the Without Notice Clause incorporated in the Confirmations and the notice provisions in the ISDAs, the Confirmations would prevail.

The Court concluded, however, that there was no such inconsistency.

The Court, citing the Privy Council decision in *Yien Yieh Commercial Bank Ltd v Kwai Chung Cold Storage Co Ltd* [1989] 2 HKLR 639, held that the rejection of one clause in a contract as inconsistent with another involves a rewriting of the contract. This can only be justified in circumstances where the two clauses are, in truth, irreconcilable. Where the document has been drafted as a coherent whole, the overwhelming probability is that, on examination, apparent inconsistency can be resolved by the ordinary process of construction.

The Court went on to adopt the approach expounded by the UK Supreme Court in *Geys v Société Générale, London Branch* [2013] 1 AC 523. The case held that where a contract or a series of contracts which form part of the transactional relationship of the parties provide alternative means/rights to terminate a contract, the Court's approach should be to:

- ask itself if any of the provisions are framed mandatorily or permissively. In the latter case, the Court can conclude that the use of permissive language in

one document amounts to a reservation of that party's rights to provide for alternative means in other documents or within the same contract; or

- do its best to see if the seemingly inconsistent provisions can be reconciled.

Applying the above approach, the Court held that as both the Without Notice Clause in the CSNL and the notice provisions in the ISDAs were framed permissively, the rights of termination afforded to the Bank under the agreements existed in parallel to each other.

Significantly, in responding to the points advanced by ST's expert witness, the Court held that an ISDA Master Agreement must be "*interpreted in a manner that allows parties to customize their rights by amending the relevant agreement or by way of separate agreements... as the ISDA Master Agreement often forms part of a broader transaction relationship"*.

This conclusion was supported by the Entire Agreement Clause (the Entire Agreement Clause) in s 9(a) of the ISDAs, which provided that the terms of the ISDAs were without prejudice to the Account Agreement, "*comprising the Account Mandate and Terms and Conditions and all other documents executed ancillary or in connection thereto*", which would include the CSNL.

Duty of care in unwinding the Accumulators

ST argued that the Bank had a duty of care in contract to conduct the close-out exercise competently and with reasonable care; and that this contractual duty of care had been breached by the manner in which the Bank had unwound the Accumulators.

In its judgment, the Court appeared to agree with ST that the Bank was under such a duty of care (although it did not explicitly address the issue), and went on to consider ST's argument that this duty of care had been breached.

The Bank had first disposed of positions that it had taken in the underlying shares as a result of entering into the Accumulators (termed the Delta Shares). The Delta Shares were then sold over the course of the day at a close to the volume-weighted average price (VWAP) of the underlying shares (the VWAP Method). ST's argument was that the Bank should have used the spot price of the underlying shares rather than the VWAP.

In dismissing ST's argument that the Bank had breached its contractual duty of care, the Court upheld testimony from the Bank's witnesses which stated that the VWAP Method was a reasonable method of disposing of shares and standard practice in the industry, particularly when relatively large blocks of shares were involved.

It is interesting that the Court elected not to elaborate on the content of the Bank's contractual duty of care, instead focusing on the more narrow question of whether the Bank's unwinding of the Accumulators would constitute a breach. In view of the Court's approach, the English Court of Appeal's decision in *Socimer International Bank Limited v Standard Bank London Ltd* [2008] EWCA Civ 116 may be instructive.

The case held that a bank's discretion in valuing securities is not absolute. It is limited by concepts of honesty, good faith and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. However, the English Court of Appeal also refused to imply into the agreement the further limitation that the discretion should be exercised reasonably with regard to the interests of the defaulting party, it being neither necessary as a matter of business efficacy nor sufficiently certain. Despite not explicitly addressing these points, the Court's decision that the VWAP Method used by the Bank did not breach its contractual duty of care is consistent with the above approach.

ST also argued that the Bank was negligent in unwinding the Accumulators when the markets were depressed i.e. that the Bank should have waited for a more buoyant market so as to obtain a better price when disposing the shares.

The Court was not impressed by ST's argument, dismissing it as containing a "*fair amount of ex post facto reasoning*".

Although it is unclear, in addressing ST's arguments the Court appeared to agree with ST that the Bank was under a tortious duty of care. This seems to be at odds with the position currently taken by the English courts.

In *Euroption Strategic Fund Ltd v Skandinaviska Enskilda Banken AB* [2012] EWHC 584 (Comm), the court held that while there was a duty to act rationally while closing out positions pursuant to a missed margin call, no tortious duty of care arose. The court's reasoning for this was twofold. First, that the commercial relationship between the parties was not an appropriate relationship for such a duty of care to be imposed; and second, that imposing a tortious duty would involve a new type of loss not recognised by tort, namely loss of hypothetical investment opportunities.

Although the latter reason appears to have been implicitly recognised by the Court in its dismissal of ST's argument, it remains important to note that the Court's decision differs from the English position as to the existence of a tortious duty, if not the final result.

Closing out by statements of calculation

ST made an additional argument that the Bank did not provide him with statements of calculation as required under the 2006 ISDA Master Agreement. This was based on the requirement in s 6(d)(i) for "reasonable detail" to be set out in the calculation statements; and s 12(a), which provided that the calculation statements may not be given "by facsimile transmission or electronic messaging system" (the calculation statement having been provided to ST by e-mail).

The Court held that the calculation statements sent by the Bank to ST provided "reasonable detail" on the basis that they "*state the price at which the respective Accumulators were unwound and the Unwinding Costs*".

The Court appeared to be taking an approach which was less strict than the English court's decision in *Goldman Sachs International v Videocon Global Limited* [2013] EWHC 2843. In the case, the court held that the purpose of a calculation statement was to enable a reasonable understanding of how the figures were arrived at, and should assist the receiving party with forming a view (assisted if necessary by advice) as to whether the determination of loss satisfied the contractual requirements of reasonableness and good faith.

Given that the Court had already held there was a superseding oral agreement, s 6(d)(i) of the 2006 ISDA Master Agreement was *prima facie* inapplicable. The Court nonetheless went on to imply a term to the oral agreement that the Bank was to inform ST of the costs of unwinding the accumulators and the price at which the accumulators were unwound; and that such information could be provided to ST via e-mail.

The Court's decision that communication via e-mail was sufficient sits uneasily with s 12(a) of the 2006 ISDA Master Agreement. In particular, in *Greenclose Ltd v National Westminster Bank plc* [2014] EWHC 1156 (Ch), the English court held that e-mails do not constitute an "electronic messaging system" under the 1992 ISDA Master Agreement, and therefore was not an effective means of communication.

Conclusion

The Court's finding that there was a superseding oral agreement between the parties to unwind the Accumulators was sufficient to determine this case. As such, it is apparent that banks should be particularly diligent in keeping documentary and oral records; these having substantial evidential value.

However, the Court's *obiter* comments demonstrate the significance of the wider commercial relationship between the contracting parties in construing the terms of the ISDAs and the related suite of documentation. The Court's reading of the termination clauses and the Entire Agreement Clause also reveals a permissive approach to the scope and extent of "without notice" termination rights afforded to banks in their contracts with private counterparties.

The case nevertheless highlights the attention that should be paid to the specific terms of agreements governing the general account and credit relationship, when entering into derivatives transactions in a private wealth context.

Finally, the Court's comments on the standard of care required of banks when exercising their termination rights is helpful guidance on the manner in which banks may unwind transactions in the event of a default.

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