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Close-outs – a recap following the UK's Brexit vote

During the financial crisis, many institutions became well-acquainted with the close-out and valuations provisions of various contracts, as counterparties failed to meet margin calls and/or entered insolvency. In recent years there has been less cause to look at these provisions, while a body of case law post-financial crisis has provided additional guidance for institutions facing the need to close out transactions. Market volatility on Friday 24 June is expected to lead to margin calls in the following week, so this note sets out some reminders for institutions dealing with failures to pay to bear in mind, in particular in light of case law on these issues. This note considers close outs/terminations in general terms, rather than by reference to particular types of contract or particular contractual terms.

One overarching point to stress whichever contract applies to the transaction in question is the importance of complying faithfully with the contractual provisions. In any dispute, a party's actions will be tested by reference to the provisions of the contract, which the English courts will strive to uphold.

Valuations on which margin call is based

One of the triggers for margin calls in 2007 and 2008 was the mass revaluation of CDOs and CLOs, following mass rating downgrades. This inevitably led to challenges by counterparties subject to margin calls and close-outs when they failed to meet the margin calls.

Where products are priced by reference to published prices, the risk of challenge is limited, but institutions pricing by reference to their own internal models should be alive to the possibility of challenge to valuations and margin calls based on those valuations, and must be prepared to provide back-up to support those valuations, while at the same time being alert to the use of challenge as a stalling tactic.

Notices

It is critical for notices served on counterparties terminating transactions to be correct in every respect to minimise the risk of challenge. This means detailed examination of the relevant contract to ensure that notices are issued and served on the right day, served on the right counterparty at the right address and using a contractually specified method for service, and that the correct date for termination is specified.

The same applies for follow up notices containing the details of close out calculations.

Valuing the transactions

Again, the terms of the applicable contract must be examined in detail to determine the obligations on the non-defaulting party as to what pricing sources should be used and how a valuation should be arrived at.

Many institutions will have policies and processes in place to prescribe how close outs should be carried out. As far as possible, those policies should be followed to the letter, to avoid claims that failure to follow the policies in itself rendered the process invalid. Where that is not appropriate in any particular case, the reasons for departing from the policy should be documented.

Similarly, a detailed, non-privileged, record should be kept of what steps have been taken to arrive at valuations, documenting what pricing sources have been selected,

when they were consulted/contacted and how, what information any institutions asked to bid or quote were provided with and what timeframe they were provided with to respond, when and how institutions were chased and what responses were received.

Traders and others involved in the close out process need to be aware that, in the event of a dispute, every element of the process and the surrounding circumstances (including the trader's own book, other orders, market data and all internal and external communications relating to the close out) will be available to the court and the counterparty and scrutinised in detail.

Any institution which decides to take assets onto its own books must be alive to the likelihood that this will be susceptible to challenge unless it can show conclusively that its bid was higher than any other bids sought, and that the process followed to obtain other bids was unimpeachable. Any auction process must be a genuine one, ie the assets must be available for sale.

Obligations on non-defaulting parties when valuing transactions

The starting point for ascertaining the obligations of the party valuing the transactions will be the relevant contract, but case law has also provided some assistance when considering the role of a non-defaulting party in this position.

As a general rule, the only obligations on a non-defaulting party (absent contract-specific requirements) are to act rationally and in good faith. It is not necessary to put the interests of the defaulting party ahead of the non-defaulting party's interests, and a non-defaulting party will generally not owe a duty of care to the defaulting party.

Communicating with counterparties

The situation in which a counterparty has failed to post margin is a stressful one on both sides and it is easy for the parties to say or write things in the heat of the moment which in the cold light of a courtroom some years later they will regret.

While it might be tempting to respond to such a situation by closing down lines of communication completely, that will generally be an over-reaction and may be as counter-productive as over-emotional exchanges.

Counterparties will usually want to continue to speak to their relationship contact at the institution, whose loyalties may be torn at this point. It is preferable once in an enforcement situation for communication to be passed instead to a different individual within the bank, preferably with experience of similar situations, who will be able to deal with the situation in a dispassionate and cool-headed way.

Broader issues

Challenges to close outs may not be the only challenge institutions face following close outs. Counterparties will frequently take the opportunity also to challenge the basis on which the product or transaction was sold to them in the first place. Potential challenges in that context may include misselling, misrepresentation, failure to disclose material information or risks, or claims of ultra vires.

Such claims may also provide a basis for counterparties to attempt to challenge or ignore jurisdiction clauses which no longer suit, but which might be harder to challenge on valuation issues alone.

Conclusion

Close outs offer many potential traps for the unwary and there are obvious incentives for defaulting parties to try to challenge the process at every step.

Careful scrutiny of the relevant contract will assist in avoiding many of those traps, coupled with appropriate legal advice, whether internal or external.

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