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Investor **Alert**

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What claims might be available to institutional investors in the structured finance and derivatives markets? Part three - Pricing and valuation disputes

The purpose of this series of Investor Alerts is to give some assistance to investors in understanding the sort of claims that might arise under English law in relation to defaulted or poorly performing structured finance products.

The September 2010 and January 2011 editions considered mis-selling and contractual disputes, and mismanagement claims respectively. We now turn to our last category of claim: mis-pricing/mis-valuation.

Foreword – and a case alert

In this final edition in this series, it is worth pointing out that our categorisation of the four broad types of claim is of course a simplification, and in reality matters are rarely so simple as to fit neatly into just one category.

A fitting example of this is the landmark judgment which the Federal Court of Justice in Germany, the Bundesgerichtshof, announced on 22 March 2011. The dispute on appeal concerned a 'spread ladder swap' between Deutsche Bank and Ille Papier Service GmbH. In summary, the former agreed to pay 3% interest on €2m over a period of five years in exchange for the payment by the latter of 1.5% on the same in the first year and a variable rate thereafter. Ille Papier ended up accruing losses and it had paid a lump sum in order to terminate the transaction. It sought to recover its losses claiming that it was not given adequate advice as to the nature of the swap. The Bundesgerichtshof found that in the circumstances of such a complex product, Deutsche Bank owed Ille Papier a duty to advise, and was not simply to be regarded as a market counterparty in respect of the transaction. Although Deutsche Bank claims to have accurately represented the risks involved, including the risk of potentially unlimited losses, the court accepted Ille Papier's arguments that Deutsche Bank should have disclosed its profits that were built into the Swap and its conflict of interest resulting from it being both an advisor and a seller. It was held that for products of this complexity, the bank should have revealed the profit it earned upfront,and should have been much more explicit in spelling out the risks of the transaction. As is evident, there is a clear cross-over here between issues of mis-pricing, misrepresentation and contractual duty.

Comments

This Alert is simply an overview of one type of claim which arises in relation to structured finance transactions. As noted, these are complicated areas where detailed legal and expert assistance is required. Accordingly, investors should seek such assistance at an early stage when considering what claims may arise as a result of losses incurred on structured finance transactions.

The decision by the Bundesgerichtshof to allow Ille Papier's appeal and overturn the decision of two lower courts has wider implications for Deutsche Bank and the industry as well. Related disputes over swaps involving Deutsche Bank number at 25 and further disputes are expected as an estimated 700 towns and cities are reported to have entered into similar transactions.

Background to Pricing/Valuation Disputes

Where there is any secondary market at all for structured finance and many derivative products, it is commonly limited. Furthermore, the data required to perform a proper systematic valuation can be difficult to obtain, particularly for more complex and esoteric structures. However, when transactions collapse, some means has to be found for valuing them in order to close them out. Normally in this arena, this is through one of the ISDA close-out mechanisms. In times of market stress, those mechanisms inevitably come under scrutiny.

ISDA Valuation Provisions

ISDA 1992: 'Loss' and 'Market Quotation' Valuation

Those familiar with the history of the ISDA documentation will know that 'Close Out Amount' valuation was introduced in the 2002 Master Agreement to overcome perceived deficiencies in the 1992 Master Agreement's 'Loss' and 'Market Quotation' mechanisms.

Not least, ISDA was disappointed with the ruling in *Peregrine Fixed Income Limited v Robinson Department Store Plc*[1], in which the parties' contractual election for "Market Quotation" was set aside in favour of "Loss".

Under the CDS in issue Robinson was obliged to pay Peregrine $6.25m a year for 25 years. Peregrine defaulted, by going into bankruptcy. As the non-defaulting party, Robinson sought and received market quotations for taking over Peregrine's side of the CDS. It was bid $750k, $9.5m and $25.5m, and accordingly, under the Market Quotation mechanism the close out value was $9.5m.

The price for taking over the benefit of Robinson's commitment to make future payments was so low because Robinson was itself a very poor credit (and duly underwent a restructuring shortly after the court case). Discounted at standard dollar swap rates, the then present value of Robinson's obligations was some $87.3m. This troubled the judge, who held that the $9.5m Market Quotation price must therefore be a commercially unreasonable result. Further, he held that the calculations under the Loss measure should not take into account the fact of Robinson's poor credit.

The judgment has been widely criticised – not least from within ISDA – but it remains the leading English law precedent on the application of the close out valuations under the 1992 ISDA Master. The moral is evident: an opposing party's valuation result should never be taken at face value even if it appears to have followed the relevant provision to the letter.

A dealer poll might seem a straightforward mechanism, but the terms on which it is conducted bear close examination, particularly for more complex instruments. In such cases it is possible for the terms to be subtly distorted so as to maximise the economic advantage of the party carrying out the poll. In our experience it can be possible to negotiate significant improvements in terms, where it is possible to expose such distortions through expert evidence.

Valuation Methods under the 1992 ISDA Master Agreement:

"Loss"

The non-defaulting party is required to determine, on the early termination date or as soon as possible thereafter, its total loss and costs. It must do so reasonably and in good faith, and may use market quotations as a reference when determining the loss.

"Market Quotation"

On or as soon as possible after the early termination date, the parties ask reference market makers for quotations.

If three or more quotations are obtained, the highest and lowest are discarded and the market quotation is the arithmetic mean of the quotations that remain.

If fewer than three quotations are received, it is deemed impossible to determine a market quotation (and the calculation reverts to the loss method).

ISDA 2002: "Close-Out Amount" Valuation

The 'Close-out Amount' mechanism embodied in the 2002 ISDA Master Agreement contains elements of market quotation, albeit as one source of pricing information rather than a primary or sole source. However, this mechanism also raises a whole new set of concerns. By its introduction, ISDA sought to elevate internal price modelling into a valuation mechanism, albeit one subject to certain checks and balances (such as market price information). As ISDA is a representative organisation for the dealer community, it is not surprising that more discretionary means of valuation were being sought. In 2002, a certain faith in the ability of modelling to output objective and accurate information perhaps chimed with the times. That is surely no longer the case.

The only reported English case on the Close-out Amount mechanism is the less than fully-formed challenge in *BNP Paribas v Wockhardt*[2], in which the High Court dismissed an argument that an amount determined by BNP Paribas was either (a) commercially unreasonable or (b) an unenforceable 'penalty'. Critically, however, Wockhardt had not adduced any evidence to challenge the basis of the pricing model, so those remarks were based on the unopposed evidence produced by BNP Paribas. That may be because the transaction was a vanilla foreign exchange swap for which the pricing was difficult to dispute.

Obviously, the more complex the product, the more complexities are introduced to the pricing models, and hence more room arises for challenge by opposing parties. What the case does show is that the party wishing to dispute a valuation has to put the work into bringing before the court convincing expert evidence supporting its case that the pricing/valuation exercise was flawed.

Other Recent English Valuation Cases
"Sole and absolute discretion"

In many instances, the terms are even more permissive and discretionary for the determining party than the ISDA mechanisms. An instance is *Socimer International Bank Limited (in liquidation) v Standard Bank*[3]. In that case, the Market Value was defined as *"the value… determined by the Seller in its sole and absolute discretion"*. Unlike the ISDA "Loss" formulation, the contract in question did not say that Standard Bank had to exercise that discretion *"reasonably"* or in *"good faith"*. Were there any such limits to the exercise of Standard Bank's *"sole and absolute"* discretion? Lord Justice Rix's answer was that *"it is plain from these authorities that a decision-maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith, and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality"*. Elsewhere in his judgment he indicated that a *"manifest error"* would also be excluded. However, he rejected the suggestion that the process or the resulting value had to be reasonable. Accordingly, although there are some limits imposed on such a decision-maker, they are not onerous. That does not mean that a challenge cannot succeed, and the *Highland Financial* case discussed further below provides an example where such a test would have been failed.

Valuation Method under the 2002 ISDA Master Agreement

"Close-out Amount"

"[a] more flexible method of calculation which combines both the market quotation and loss methods. The close-out amount will include losses or gains to the determining party in order to replace the transaction with its economic equivalent. The amount will be determined by the determining party, which will act in good faith and use commercially reasonable procedures in order to produce a commercially reasonable result."

The recent case of *WestLB v Nomura*[4] considered a very similar clause, which also permitted Nomura to value (in this case shares held in an emerging markets equity fund) at its sole discretion. Nomura chose to carry out a dealer poll for the shares in the fund, which got a nil return, on the basis of which Nomura valued the assets at nil. The judge considered that *"the value of an asset is what someone is prepared to pay for it"*. While that seems uncontroversial, it goes some way to reinstating a level of objectivity to the pricing exercise. The judge held that Nomura's failure to seek a redemption price from the fund itself made the valuation irrational and thus unlawful. Unfortunately for WestLB, the judge then found that it had failed to establish that the fund would have redeemed the shares at a price which would give WestLB a claim in damages.

Compromised Pricing Exercises

The latest valuation judgment from the English courts is that in *RBS v Highland Financial*[5]. This concerned a prospective CDO ("Highlander V"), which was caught up by the credit crisis in the warehousing stage. The core issue was that RBS purported to carry out an auction of the 88 reference assets. In fact RBS had moved 36 of the assets onto its long-term books (before the auction) so as to capture a £28.5m accounting gain. The client hedge fund was not informed of this, and RBS proceeded as if the auction was of all 88 assets. In fact, RBS could not have sold the assets it had already taken over as 'long-term holdings', so it invented fictitious counterbids in order to decline the highest bids on those assets and then used the highest bid as the price for its own purchase. The judge held that *"these lies … did not constitute a sales process which was commercially reasonable"*. Further, he found that the process meant that *"there could be no possibility of high pressure salesmanship"* for any of the 88 assets. The judge found that the prices in a real auction would have been substantially higher.

Conclusion

Whatever the content of valuation/pricing clauses, what can be said with certainty is that unilateral pricing/valuation decisions deserve the closest of scrutiny given the conflicts of interest which often arise. In our experience, significant improvements can be achieved by analysing and challenging valuations provided by counterparties and the methodologies behind them. In appropriate circumstances, it is clearly in the investor's best interests to test and challenge valuations and advance alternatives.

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(1) [2000] Lloyd's Rep Bank 304
(2) [2009] EWHC 3116 (Comm)
(3) http://www.bailii.org/ew/cases/EWCA/Civ/2008/116.html
(4) http://www.bailii.org/ew/cases/EWHC/Comm/2010/2863.html
(5) 2010] EWHC 3119 (Comm)

This is a summary of certain matters of English law. It should not be regarded as a substitute for advice on how to act in any particular case. For further information please contact one of the authors.

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