

Summary

On 12 May 2015, the English High Court provided guidance on the interpretation of the Loss provision under the 1992 ISDA Master Agreement in its judgment in *Fondazione Enasarco v Lehman Brothers Finance S.A.* and another [2014] EWHC 34 (Ch). The judgment will be of interest to participants in the derivatives markets as it provides:

- a) The calculation of Loss can be made by reference to the cost of a replacement transaction;
- b) A calculation of Loss made several months after the Early Termination Date can be considered to have met the contractual requirements of the 1992 ISDA Master Agreement for Loss to be determined as of the Early Termination Date or the earliest date thereafter as is reasonably practicable;
- c) The terms of a replacement transaction do not necessarily have to be identical to the original transaction; and
- d) Only in limited circumstances will the defaulting party be likely to be able to successfully challenge the non-defaulting party's determination of Loss.

The judgment is reassuring for end-users as it preserves the recognition of a wide scope of calculation methodologies on a termination of a 1992 ISDA Master Agreement.

Facts

Fondazione Enasarco (Enasarco), the Italian pension fund for sales representatives, had made a structured investment in principal-protected notes issued by a special purpose vehicle. The principal of these notes was protected by a cash-settled put option provided by Lehman Brothers Finance S.A. (Lehman) and documented by the 1992 ISDA Master Agreement. As a result of Lehman's collapse in September 2008 the put option was terminated.

The provisions of the 1992 ISDA Master Agreement required the pension fund to calculate its loss, being "the amount [it] reasonably determines in good faith to be its total losses and costs", "as soon as reasonably practicable" following the Early Termination Date. Enasarco entered into substitute arrangements for the transaction in May 2009 (around seven months after the Early Termination Date). It calculated its losses as being US\$61,507,902 which was the difference in the premium payable under the put option with Lehman and the replacement derivative trade. This amount was challenged by Lehman who argued that the time period to find a replacement transaction was not "reasonably practicable".

Judgment

Enasarco's Loss calculation was found to be valid and in accordance with the requirements of the 1992 ISDA Master Agreement. The Court rejected Lehman's argument that "reasonably determines in good faith" within the Loss definition provided an objective standard of care. Whilst finding that Enasarco had treated the matter with urgency and did not intend to cause delay, it found that the requirement to make the Loss determination on the earliest date that is "reasonably practicable" did not mean on the earliest date that is "possible". The Court also took into account the extensive loss of confidence and high uncertainty which the Lehman collapse had caused in western economies. Against the backdrop of these difficult market conditions, the Court recognised that replacing such an investment, given its size, complexity and restructuring need, was difficult; the near seven months taken to find a replacement and calculate losses was, therefore, within a "reasonably practicable" timeframe after considering all of the circumstances of the case. It rejected Lehman's arguments that hypothetical prices could have been used rather than waiting for a real price, finding that the need for "quotation of relevant rates and prices" had the same meaning as in the "Market Quotation" definition, which was interpreted as requiring a real offer in *Lehman Brothers Finance SA v Sal Oppenheim JR & Cie KGAA* [2014] EWHC 2627.

The Court utilised the *Wednesbury* reasonable test in coming to its conclusion (*Associated Provincial Picture House Ltd v Wednesbury Corporation* [1948] 1 KB 223). The *Wednesbury* test is whether the Loss calculation was one which a reasonable non-defaulting party could have come to. Consequently, unless it can be shown that irrelevant matters were visibly considered, this test will make it difficult to successfully challenge a non-defaulting party's Loss calculation. Moreover, given the difficult market conditions, the Court found that it was appropriate for the replacement transaction to not be on identical terms to Lehman's; the "Market Quotation" definition did not require equivalent performance prospects by the counterparty and the deterioration of the portfolio's average liquidity was "simply" a result of the changed market conditions.

We would be pleased to discuss with you in more detail any of the matters raised in this briefing or any matters that there was not space to address.

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