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CORONAVIRUS: CLOSE-OUTS – WHERE ARE WE NOW?

Coronavirus has caused disruption and volatility to the financial markets leading to margin calls and settlement disruptions with the result that defaults may become more widespread. This note sets out some reminders for institutions dealing with failures to pay or deliver to bear in mind, looking at close outs and terminations in general terms.

This note considers the position under English law (as a common choice under industry documentation). Many of the same issues will arise for contracts with other governing laws, albeit the courts may reach different conclusions.

Whilst regulation has come into force designed to prevent some of the issues which arose during the financial crisis, and institutions are increasingly relying on technology and outsourced functions to calculate and pay margin, these innovations have not yet been tested in volatile markets.

We assume for the purposes of this note that institutions would elect to terminate in the event of a default, noting that that decision is not always an easy one and that taking too long to make a decision gives rise to its own issues.

One point to stress, regardless of what type of agreement 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.

Notices

It is critical for notices served on counterparties terminating transactions to be correct in every respect in order to minimise the risk of challenge. This means a detailed examination of the relevant contract to ensure that notices are served by the relevant time 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.

Force majeure

In some cases, failure to perform may be as a result of force majeure or another disruption event. The precise wording of the contract will be key here to determine whether such an event has arisen and the consequences.

Valuing the transactions

Again, the terms of the applicable contract 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 and associated templates for notices. These may need to be reviewed and updated to take account of changes to how valuations and margin payments are carried out, including the use of technology and outsourcing of these functions. Institutions will need to be comfortable that relevant individuals are conversant with the inputs used and calculations carried out to arrive at valuations, including where these are done by third parties, as these will need to be documented in the event of a challenge or a close-out situation. Any issues identified as part of this exercise should be remedied as soon as possible.

As far as possible, close-out policies should be followed to the letter, to avoid claims that the 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.

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.

Margin, custodians and collateral managers

Added complexity for close-outs and terminations of non-cleared derivatives arises from the introduction of mandatory initial and variation margin requirements, the involvement of a custodian and a charge over the assets posted for initial margin (rather than outright title transfer) and the use of third party collateral managers and automated tools for managing margin. While these changes are designed to give greater protection to both parties to a derivatives contract, the mechanisms and how they operate in a default are not yet tested and could give rise to challenges. For example, if a defaulting party challenges the valuation arrived at and therefore the sums payable, but the dispute is only resolved some time later, the non-defaulting party will be liable in respect of any dealings with the collateral in the meantime.

Custodians and collateral managers may find themselves facing difficult decisions where there are disputes between counterparties as to whether or not they should release collateral and whether or not the security has become enforceable.

Increased reliance on automated tools and third party collateral managers may lead to additional issues and disputes should it become apparent that technological failure or mistake, or errors by third parties carrying out outsourced functions, have contributed to valuation or close out disputes.

Conclusion

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

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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J202004032022229