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May 2019

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On 22 February 2019 the High Court handed down judgment in the case of Lehman Brothers Finance AG ("LBF") (in liquidation) v Klaus Tschira Stiftung GmbH ([2019] EWHC 379 (Ch)), a case concerning the determination of "Loss" following an Automatic Early Termination ("AET") under a 1992 ISDA Master Agreement. The ISDA Master Agreement governed a number of large equity collar hedge transactions entered into by the defendants to protect themselves against the drop in value of shares in SAP. The case involves a discussion of the non-defaulting party's (NDP) broad discretion as to the methodology of calculating Loss under a 1992 ISDA Master Agreement but goes on to determine that such discretion does not extend as to what should fall within Loss. It also confirms the relevance of the general principles of breach of contract at common law, in particular the compensatory principle of damages and the principles of remoteness and mitigation.

The Judge (Mr Justice Snowden) concluded, amongst other things, that the defendants had not correctly determined their "Loss". More specifically,

- The defendants should have used quotations taken "as of the relevant Early Termination Date, or, if that is not reasonably practicable as of the earliest date after the Early Termination Date [15th September 2008] as was reasonably practicable". In fact the defendants had used later quotations (on 16th October 2008 following a significant drop in the price of the SAP shares underlying the transactions) arguing that in the intervening period they were attempting to mitigate their loss by obtaining the return of their collateral from their custodian, Lehman Brothers International Europe ("LBIE"), by then itself having gone into Administration.
- In claiming for additional amounts related to collateral problems the defendants had not properly construed the definition of Loss. The Judge found that the additional amounts, caused by the defendants' inability to provide collateral, were not within the reasonable contemplation of the parties and therefore too remote to be claimed.
- The determination of Loss was not rational since, (i) contrary to the now well-established principle of valuing "clean", it referred to quotations for an uncollateralised transaction when it was a condition of the original transactions that they be collateralised, and (ii) on the facts the defendants would not have been able to find a market counterparty that would have entered into the replacement transaction on an uncollateralised basis.
- The Judge substituted his own Loss determination based upon his findings of what would have been arrived at by the Defendants had they, as required by the terms of the 1992 ISDA Master Agreement,

acted reasonably and in good faith, and otherwise in accordance with the proper interpretation of the Loss definition (i.e. based upon quotations or valuations for collateralised replacement transactions as of a date as soon as reasonably practicable after the Early Termination Date). The Judge's Loss determination was based on the average of the two market maker quotations for collateralised replacement transactions of 15th September 2008 and was €22.84 million (payable by LBF to the defendants). This was vastly different to the defendant's Loss determination of €511.13 million (owing to them from LBF) which was based on the 16th October 2008 quotations for uncollateralised replacement transactions. Indeed, after the Independent Amount held by the defendants was taken into account the defendants now owe LBF under the close-out.

We understand that as yet no decision has been taken on whether this case will be appealed.

Key Facts of the Case

In May 2007 the Defendants, Klaus Tschira Stiftung GmbH, entered into a number of collateralised equity collar transactions (known as variable forward sales "VFS") with a member of the LBF to protect themselves from the reduction in value of their principal asset being a very large volume of shares in SAP. As a condition of the transactions they granted collateral over 59 million SAP shares which were then held in a segregated custody account by their custodian LBIE. The parties entered into 1992 ISDA Master Agreements with Automatic Early Termination applicable and Loss elected as the Payment Measure. In April 2008 the defendants partially unwound the VFS transactions by entering smaller reverse transactions (known as variable forward purchases "VFP") with LBF.

On 15 September 2008 Lehman Bros Holding Inc. (the ultimate US parent company) went into bankruptcy in the US triggering Automatic Early Termination under the transactions in question. The defendants initially sought quotes from two market makers for replacement transactions on a collateralised basis on 15th September 2008. These transactions were by any measure huge and it was common ground that any market counterparty would have needed to enter into significant delta hedging arrangements involving the SAP shares.

In early October 2008 SAP shares dropped significantly in value from €40 to €26 per share. By mid-October, due to their custodian LBIE entering Administration, it became clear that the defendants would not be able to get the prompt return of their SAP shares held as collateral. The Judge determined that none of the parties had anticipated on the trade date such an event or the possible impact on the defendants' ability to enter replacement transactions if the need arose. Due to the difficulties the defendants sought quotes from market makers for replacement transaction on an uncollateralised basis. The uncollateralised replacement transactions quotes were substantially larger than the initial quotes and led to the defendants claiming a far larger Early Termination Amount from the Claimant, of €511.13, due in large part to the drop in the value of SAP shares.

The Claimant successfully claimed that the Loss had been incorrectly calculated. The judge determined an alternative Loss calculation based upon an average of the two initial quotes for collateralised replacement transactions, €22.84 million.

Definition of "Loss"

Discretion - The Judge concluded that the non-defaulting party (NDP) had the discretion to use any methodology for the calculation of Loss so long as that methodology is reasonable and is used in good faith. However the Judge did not believe the NDP had similar freedom to decide what matters can be included within the meaning of Loss.

"Whilst LBF agreed to be bound by the method selected by the defendants to determine their Loss (provided that it was selected and applied reasonably and in good faith), I do not consider that LBF also agreed to be bound by the defendants own interpretation of what the Master Agreements permitted them to include in the expression "total losses and costs (or gain)" in the Loss definition." [Mr Justice Snowden para 179]

The Judge referred to Briggs LJ judgment in Lomas v Firth Rixson in which he gave a helpful summary of the broad propositions from previous authorities:

- Loss and Market Quotation are, although different formula, aimed at achieving broadly the same result, so that outcomes derived from one may be usefully tested by way of cross-check by reference to the other.
- The identification of the NDP's loss of bargain arising from the termination of a derivative transaction requires a "clean" rather than a "dirty" market valuation of the lost transaction i.e. based on an assumption that the transaction would have proceeded to a conclusion and that all conditions to its full performance by both sides would have been satisfied, however improbable that assumption may be in the real world.
- The ISDA Section 6(e) termination payment formulae are not to be rigidly interpreted in accordance with damages for breach of contract at common law however the Judge entirely accepted the validity of having regard to common law principles. In particular the compensatory principle, which requires that the injured party is, so far as money can do it, to be placed in the same situation with respect to damages as if the contract had been performed. Furthermore, the Judge also agreed with previous authorities which have determined that the use of a substitute contract for measuring the loss of bargain at common law also reflects the principles of remoteness of damage and requirements of mitigation.

On the facts of this case the Judge considered the wording of Market Quotation to advise his interpretation of the correct timing of the Loss calculation and on the nature of the quotations (firm / indicative) which must be provided. The Judge concluded that the NDP has some discretion on timing and as such:

- The definition of Loss does not necessarily limit the NDP to

valuations by reference to the Early Termination Date.

- The determination of the defendants' loss of bargain should have been based upon quotations or valuations for collateralised replacement transactions as of the earliest date after the Early Termination Date as is reasonably practicable.

Moreover, when choosing to use quotations to determine Loss, the Judge agreed that the defendants need quotes for trades that are executable (i.e. the reference to quotes in the definition of Loss was in his view to "live" or executable quotations). Those involved in giving the collateralised replacement transaction quotes in this case referred to their quotes as indicative rather than firm however on the facts the Judge determined that in reality the quotes for executable collateralised replacement trades would have been the same as those obtained by the defendants.

As such the Judge felt able to use those quotes when determining Loss.

Remoteness and Mitigation

The Judge determined that the words "total losses or costs" used in the definition of Loss is a reference to the aggregation of losses rather than implying an unrestricted indemnity for all losses de facto resulting from the termination of the transaction. He agreed with previous authorities that the definition of Loss is illuminated by common law principles. On the facts the Judge concluded that the defendant could not claim additional amounts caused by their own inability to provide collateral since,

- The additional amounts were too remote i.e. it would not have been within the contemplation of the parties that if the hedge transaction were terminated due to the bankruptcy of LBHI, the defendants would not only suffer the loss of the contractual obligations owed to them by LBF, but would also suffer great loss by reason of being unable to recover their own collateral from LBIE so as to be able to use it in obtaining replacement transactions.
- The additional amounts were losses of a very different kind from the loss of payment obligations between the defendant and LBF.
- The defendants' attempts to obtain the return of collateral was not mitigation that would entitle them to increase their claim rather it was a separate matter of the defendants seeking return of their asset.

Determination Not in accordance with ISDA close out

The Judge confirmed that the NDP should be entitled to select any methodology for calculating Loss, so long as the methodology is reasonable and used in good faith. However the discretion is not unlimited so the NDP cannot decide for itself what Loss meant in the ISDA. The Judge concluded that the defendants' Loss calculation was not in accordance with the close out provisions of the ISDA 1992 Master Agreement moreover the determination of Loss was not in his view rational since:

- The provision of collateral was a condition of the VFS and had a

substantial effect upon pricing. Accordingly the Judge concluded that an uncollateralised replacement contract is not a reliable guide to the value of a terminated transaction which had a condition requiring it to be collateralised.
- On the facts the Judge found that the defendants would not have been able to find a market counterparty that would have executed the replacement transaction in the absence of collateral.

Judge's Loss Determination

The Judge determined the defendants' Loss using valuations actually obtained by the defendants on a collateralised basis shortly after the Early Termination Date. Two further issues were in dispute: –

- Closing vs. opening price - Both quotes used by the defendants were based on the opening price of the SAP shares on 15 September 2008. Had they used the closing price (as one expert indicated would have been more appropriate) the Early Termination Amount would have been vastly different. In fact it would have led to a payment being owed in the other direction. The Judge decided on the facts that, as it was not a fundamental error to use the opening price, he was able to use such valuations. They were merely a different methodology which was within the scope of the NDP's discretion.
- Higher borrowing costs for the delta hedge. The borrowing costs for the delta hedge used in the replacement transaction quotes were higher than the original trades. Nonetheless the Judge once again felt able to use the quotations in his Loss determination on the basis that they did not cause a significant impact.

Practical Implications

When obtaining quotations for Loss it is important to do so either on the Early Termination Date or as soon as reasonably practicable. It is clear from this case that a dim view will be taken of any attempt to "game the system" in choosing the best date to determine one's Loss.
The judge indicated a clear preference for the non-defaulting party when obtaining quotations for a Loss calculation to seek replacement transactions that are in fact executable.

When the granting of collateral is a condition to a transaction consider using a third party custodian outside of your counterparty's group to hold the collateral. This is particularly the case where without the particular collateral you would not be able to enter into a replacement transaction.

Common Law Principles

- The fundamental principle of the common law of damages is the compensatory principle, which requires that the injured party is "so far as money can do it to be placed in the same situation with respect to damages as if the contract had been performed" Robinson v Harman (1848) 1 Exch 850 , 855, Parke B.
- The traditional test of remoteness is set out in Hadley v Baxendale ([1854] 9 Ex 341). The test is in essence a test of

foreseeability so that the loss will only be recoverable if it was in the contemplation of the parties. The loss must be foreseeable not merely as being possible, but as being not unlikely.

- Chitty on Contracts (33rd ed.) describes mitigation at paragraph 26-087 in terms of three rules as follows, Page 49 "First, the claimant cannot recover damages for any part of his loss consequent upon the defendant's breach of contract that the claimant could have avoided by taking reasonable steps. Secondly, if the claimant in fact avoids or mitigates his loss consequent upon the defendant's breach, he cannot recover for such avoided loss, even though the steps he took were more than could be reasonably required of him under the first rule. Thirdly, where the claimant incurs loss or expense in the course of taking reasonable steps to mitigate the loss resulting from the defendant's breach, the claimant may recover this further loss or expense from the defendant."

Previous case law

The judgment is the most recent in a line of cases [1] considering the interpretation and application both of Loss and Market Quotation under the 1992 Master Agreement. The Judge referred to a useful summary of Briggs LJ in Lomas v JFB Firth Rixson Inc [2011] 2 BCLC 120 [at 116] of broad propositions established by authorities:

1. "Loss and Market Quotation are, although different formulae, aimed at achieving broadly the same result, so that outcomes derived from one may be usefully tested by way of cross-check by reference to the other: see per Mance LJ in the ANZ case at paragraphs 2, 15 and 22. This derived from a concession in that case, but has subsequently been reaffirmed after adversarial argument in the Peregrine case at paragraph 30, in the Britannia Bulk case at paragraphs 44 to 46 and 51, and in the Pioneer case at paragraphs 98 and 105. It is one of those sensible concessions which has hardened into hornbook law.
2. The identification of the non-defaulting party's loss of bargain arising from the termination of the Derivative Transaction requires a 'clean' rather than 'dirty' market valuation of the lost transaction. This means that the loss of bargain must be valued on an assumption that, but for termination, the transaction would have proceeded to a conclusion, and that all conditions to its full performance by both sides would have been satisfied, however improbable that assumption may be in the real world: see in the ANZ case at paragraphs 5, 22 to 27 and 30-31, the Britannia Bulk case at paragraphs 11 to 14 and 34-35, and in the Pioneer case at paragraphs 112 to 117.

3. The termination payment formulae under Section 6(e) are not to be equated with, or interpreted rigidly in accordance with, the quantification of

damages at common law for breach of contract. They are methods of calculating close-out positions on the termination of a derivative transaction or series of transactions: see the Britannia Bulk case per Flaux J at paragraph 37. This is, in particular, because the Second Method works both ways, and may lead to a close-out payment due to the defaulting party."

References

[1] ANZ Banking Group v SocGen [2000] CLC 833 (CA);

Peregrine Fixed Income Limited v. Robinson Department Store Public Co Limited [2000] CLC 1 ,328;

Britannia Bulk plc v. Pioneer Navigation Limited & ors [2011] EWHC 692 (Comm) ; and

Pioneer Freight Futures Company Limited v. TMT Asia Limited [2011] EWHC 778 (Comm)

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