COVID-19: An End-User's Guide to Margin Calls and Valuation Issues Affecting Repurchase Agreements and Swaps

Authors:
Barry B. Cosgrave
Robert T. Honeywell
Brian D. Koosed
Anthony R. G. Nolan

"I was working on something but they didn't let me finish."

Eric Dale in Margin Call, 2011

Investors in mortgage loans and securitized products have come under pressure following a severe sell-off driven by the outbreak of the coronavirus pandemic ("COVID-19"). Large price declines in all asset classes have also caused margin calls to leveraged investors. Much leverage for these asset classes has been obtained through qualified financial contracts documented as swaps or as repurchase agreements (a.k.a. "repos").

Falling and illiquid markets have practical immediate effects on parties' rights and obligations under swaps and repos. They may result in margin calls that put pressure on available resources, and that create a risk of an event of default occurring if required margin is not posted in accordance with the terms of the relevant contract. In addition, falling prices for swap collateral or purchased securities or other assets subject to repurchase on a repo facility ("repo'd assets") may trigger events of default or termination events caused by failures by a fund to maintain its required net asset value ("NAV") levels and, potentially, bankruptcy if NAV declines impair that fund's solvency.

Market turmoil also creates risks for counterparties seeking to enforce. If such counterparties call on margin or terminate transactions and liquidate posted collateral or repo'd assets, they may face allegations that they applied opportunistic and unfounded markdowns in a commercially unreasonable manner, in order to seize and sell off assets at fire-sale prices in violation of contract provisions and applicable law. The 2008-09 crisis resulted in a great deal of litigation challenging margin calls and liquidations. The COVID-19 crisis may do the same in unexpected ways.[1]

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[1] An example of the random effects of COVID-19 is seen in market dynamics affecting mortgage originators in the second half of March 2020. Many residential mortgage lenders encountered difficulties and in some case margin calls because of the declining value of mortgage loans that were subject to repo transactions in the early days of the COVID-19 crisis, causing the Federal Reserve to conduct significant open market purchases of agency-guaranteed mortgage-backed securities ("MBS"). After a week of such open market purchases, agency-guaranteed MBS valuations rose to much higher levels. While this eliminated the stress caused by falling valuations, mortgage lenders that hedged their pipelines of new originations by taking short positions in the to-be-announced (or "TBA") agency MBS market incurred severe losses on short TBA positions used for hedging purposes and in some cases suffered margin calls on those positions.

This article will provide an overview of swaps and repos, how they address valuation issues and margin posting, and certain issues arising in the context of the termination of transactions, particularly in the context of the COVID-19 crisis.

Documentation

General

Swaps are often used to provide leverage for securitized products through total return or credit default transactions, and interest rate swaps are also used to hedge interest rate risk as well as to hedge (or sometimes to speculate on) market risk of mortgage portfolios. Repurchase agreements are often used to provide liquidity and/or leverage for securities and mortgage-related assets in a super-senior form. The impact of a liquidity event in a particular case would depend to a great extent on the type of transaction, and in the case of swaps would also depend on the relevant definitions associated with the particular type of swap as well as on the elections made by the parties in the documentation governing the transaction.

Swaps

In general over-the-counter swap transactions are governed by English law or New York law, although the choice of law does not affect the master agreement used. Swaps are generally documented under two forms of standard master agreement published by the International Swaps and Derivatives Association ("ISDA"), one in 1992 (the "1992 ISDA master agreement") and the other in 2002 (the "2002 ISDA master agreement"; either, an "ISDA master agreement"), Negotiated contractual terms of general applicability to the parties' swaps relationship are contained in a schedule that supplements and often modifies the provisions of the ISDA master agreement. Each swap transaction is then documented by a confirmation that contains the basic economic terms of that transaction.

Collateral or other credit support for a swap may be provided through a guaranty or a security agreement, often in the form of a credit support annex in the form published by ISDA. For transactions governed by New York law, the credit support annex is the 1994 form (the "NY CSA"), which acts as a security agreement under New York law and provides for the creation of a security interest in cash or readily marketable securities to secure the risk, or "exposure," that either or both parties may have under swap transactions pursuant to the ISDA master agreement to which the NY CSA relates.

In the case of swaps governed by English law, the credit support annex does not create a security interest, but instead relies on a transfer of title to posted collateral to the secured party and the netting of the secured party's obligation to return that collateral against the posting party's obligation to pay any close-out amount. The 2014 English Standard Credit Support Annex (the "English CSA"; collectively with the NY CSA, the "CSA") provides for the outright transfer of title to collateral in the form of securities and/or cash subject to bilateral mark-to-market arrangements for the adjustment of the amounts of the securities and/or cash posted. Upon termination of any underlying swap transaction, the English CSA requires that all collateral held be re-transferred to the posting party, with such amount to be re-transferred deemed to be an "unpaid amount" under the ISDA master agreement. However, the value of the collateral to be returned is included within the close-out netting mechanism of the ISDA master agreement, with the enforceability of such close-out netting specifically contemplated by the UK's Insolvency Act 1986. Unlike the case under the NY CSA, the posting of collateral under the English CSA

is considered to be a transaction under the ISDA master agreement. This can have some implications for events of default and termination events under the ISDA master agreement, as discussed further below.

For uncleared swap transactions with entities that are provisionally registered as swap dealers or major swap participants under the U.S. Commodity Exchange Act or with "financial counterparties" as defined in the European Markets Infrastructure Regulation ("EMIR"), the parties are required to post and collect cash and cash-equivalent margin on a daily basis to cover changes in the market value of the transaction exposure, subject to a minimum transfer amount. In other cases, credit support requirements, including the eligible collateral categories and haircuts, are subject to bespoke negotiation. This "variation" margin is separate from initial or "independent amount" margin posted to protect against the credit risk of the posting party, the mandatory requirements for which have been delayed because of COVID-19.[2]

Transactions under the ISDA master agreement are subject to detailed sets of definitions, some of which (like the 2000 or 2006 ISDA definitions) apply generally and some of which are relevant only to particular types of transactions. Definitions provide for a variety of interpretive, valuation and disruption fallbacks (i.e., alternative remedies or value sources in the event of market disruptions) for the covered transaction categories. Examples of definitions specific to particular types of transactions include the ISDA credit derivatives definitions (2003 or 2014 version), the ISDA equity derivatives definitions (2002 or 2011 version), the ISDA 2006 fund derivatives definitions and the ISDA 1998 FX and currency option definitions.

Repurchase Transactions

The documentation for a repurchase agreement depends on the governing law for the transaction. Repurchase transactions governed by English law are documented under two forms of standard master agreement published by the Securities Industry and Financial Markets Association ("SIFMA"), one in 2000 (the "2000 GMRA") and the other in 2011 (the "2011 GMRA"; either, a "GMRA"). Repurchase transactions governed by New York law are documented under a single form of standard master agreement published in 1996 by the Bond Markets Association and currently maintained by SIFMA (the "MRA"). The GMRA is used exclusively for securities, while the MRA is also used for other assets, most notably mortgage loans.

Both the MRA and the GMRA contemplate an outright sale of the repo'd assets with an obligation to repurchase them at a specified time at a price higher than the original sale price. Although the economic drivers are the same for transactions documented under a GMRA and those under an MRA, they have technical differences that are of practical importance. While a GMRA contemplates an outright sale of repo'd assets for all purposes (subject to the repurchase obligation), the MRA is generally considered for most practical (and accounting) purposes to be a secured lending arrangement with super-senior enforcement rights following default and a special treatment in bankruptcy of either party.

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[2] On April 3, 2020, the Basel Committee on Banking Supervision and the International Organization of Securities Commissions announced that their standards for initial margin will now not come into effect until September 2021 and September 2022, respectively. On April 9, 2020 the U.S. Commodity Futures Trading Commission adopted a rule that imposes a 12-month delay in implementation of the phase-in of the U.S. requirements of initial margin on uncleared swaps.

Negotiated contractual terms of general applicability to the parties' relationship under an MRA or GMRA relationship are contained in an annex to the MRA or GMRA that supplements and often modifies the provisions of the respective form. Individual repo transactions are then documented under confirmations that may reflect additional agreed changes.

The Mechanics of Margin Calls

A margin call normally occurs when a secured counterparty determines that one or more of the assets held as collateral has decreased in value below a contractually specified margin level. The posting party must then either deposit additional assets or cash in order to reestablish the margin level, or alternatively suffer termination of the related transactions and full or partial liquidation of the collateral.

Swaps

The NY CSA reflects an assumption that the parties will wish to secure all obligations under the relevant ISDA master agreement and that the basis for determining the amount of collateral or other eligible credit support that must be provided will be primarily based on the net mark-to-market amount (the "Exposure") that one party (the "pledgor") would owe to the other party (the "secured party") if the ISDA master agreement were terminated on a full two-way payments basis (i.e., with two "Affected Parties" for purposes of determining the net close-out amount). The English CSA takes a similar approach but bases the calculation of "Exposure" on the assumption that there is only one "affected party" under the ISDA master agreement.

Both the NY CSA and English CSA include the concept of a "minimum transfer amount" which, if exceeded by the calculated Exposure of the relevant ISDA master agreement, will require the posting party to transfer collateral in an amount equal to such excess. The minimum transfer amount is a hurdle amount which is intended to limit repeated transfers of collateral between parties and is subject to negotiation depending on the creditworthiness of the customer and applicable regulatory requirements.[3] (Although the CSAs are drafted as bilateral agreements, he collateral and margin call provisions to apply only to the customer and not to the bank counterparty, unless required by the uncleared swap margin rules or negotiated by the parties.)

The calculation of transaction exposure may depend on the disruption fallbacks that apply to a transaction under applicable ISDA definitions as elected by the parties in transaction confirmations, and will also depend on whether the transaction is under the 1992 ISDA master agreement or the 2002 ISDA master agreement.[4] Typically, "Party A" (the bank offering the swap product) is selected as "calculation agent" and, among other things, makes determinations such as whether a disruption event has occurred.

Unless the parties decide otherwise, under the NY CSA the secured party is entitled to make all calculations of delivery amounts (including the calculations of exposure and the mark-to-market

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[3] The U.S. margin rules for uncleared swaps permit a minimum transfer amount no greater than US$500,000. The minimum transfer amount for uncleared derivatives margin under EMIR is €500,000.

[4] An interesting example of how COVID-19 may affect disruption fallbacks is seen in the extension of the Chinese Lunar New Year holiday by the government of the People's Republic of China in February 2020. Owing to the lateness of the announcement and the period extending over a month end, the closing of affected markets created price source disruptions that fell outside the parameters of ISDA definitions. This caused ISDA to issue a series of bespoke guidance notes for various categories of affected swap transactions.

value of posted collateral related thereto).[5] This is typically "Party A," (the bank offering the swap product), which is usually selected as the "valuation agent" for purposes of such calculations. The parties have some latitude to select the date on which relevant calculations must be made, but (unless otherwise provided) the calculation of transaction exposure and of the value of posted collateral must be made as of approximately the same time on the date chosen. Similarly in the English CSA, whilst either party may calculate the exposure, it is more common for "Party A" (i.e., the bank counterparty and the collateral taker) to be appointed as the party to undertake such calculations.

A secured party's or collateral taker's right to demand the transfer of additional eligible collateral is subject to the satisfaction of certain conditions precedent, including the absence of an event of default, potential event of default, early termination date (for which any unsatisfied payment obligations exist), or "specified condition" identified in the CSA with respect to the secured party.

Margin calls under the CSA are subject to a dispute resolution provision. If the parties cannot resolve their dispute by the resolution time specified in the NY CSA, then the valuation agent (typically the party making the demand) must perform certain recalculations. Unless the parties elect a longer period for resolution of disputes, the resolution time is 1:00 p.m., New York time (or 1:00p.m/3:00 pm London time, for the English CSA), on the local business day after the date on which the notice is given that gives rise to the dispute. (Parties sometimes change this language to refer to the date on which notice of the dispute is given in order to avoid ambiguity in the standard formulation.) If a dispute concerns only part of the margin call valuations, the pledgor is typically required to transfer the undisputed amount of eligible collateral as credit support.

Repurchase Transactions

Section 4 of the MRA and of the GMRA fixes the amount of required margin at the outset of each transaction by reference to the market value of the securities at the purchase date divided by the purchase price to give the "margin ratio" (as defined in the GMRA) or the "buyer's margin percentage" (as defined in the MRA). In either case, this is essentially equal to the contractually agreed haircut: the gap between the cash proceeds advanced by the repo buyer and the market value of the repo'd assets (the equivalent of a loan-to-value or LTV ratio in a secured loan). This margin ratio is then applied to the agreed repurchase price (i.e., the purchase price multiplied by the agreed price differential), and must be maintained as margin until the agreed close-out date of the transaction, i.e. the "repurchase date").

A margin call on the seller may arise under a repurchase transaction if the market value of sold repo securities or other assets declines in value such that the required margin ratio is breached: i.e., the aggregate market value of all repo'd assets subject to all transactions in which that party is acting as seller no longer exceeds the applicable haircut. If a transaction relates to different types of securities and the parties apportion the purchase price among the different types, the definition of margin ratio permits a separate margin ratio to be applied to each type of security. This repo provision requires margin to be calculated on a global basis for all transactions

[5] The NY CSA has analogous provisions for the return of excess collateral by the secured party to the pledgor.

outstanding under the repurchase agreement to give an overall "net exposure" (under the GMRA) or "margin deficit" (under the MRA).

In general, the MRA and GMRA each requires same-day satisfaction of margin calls. If a notice of a margin call is given at or before the notice deadline specified by the parties, the party receiving such notice must satisfy its margin maintenance obligation no later than the close of business in the relevant market on the business day on which notice is given. If the notice is given after that deadline, the party receiving such notice has until the close of business in the relevant market on the next business day following such notice.

The definition of "market value" for purposes of margin calls is generally similar as between the MRA and the GMRA – but is often carefully negotiated in amendments in annexes, so they should always be consulted when assessing the reasonableness of margin calls. The MRA defines the "market value" as the price obtained from a generally recognized source agreed to by the parties or the most recent closing bid quotation from such a source, plus accrued income on the repo'd assets to the extent not included therein (other than any income previously credited) as of such date, unless contrary to market practice for such assets. There is no separate special provision relating to valuations in illiquid circumstances, but some negotiated annexes vest discretion in selecting a pricing source in the repo buyer if the parties cannot agree. Absent such an annex amendment, one would fall back to concepts of commercial reasonableness in applicable commercial law.

The GMRA has a similar definition of "market value" with respect to any securities, as the price obtained from a generally recognized source agreed by the parties or as otherwise agreed by the parties having regard to market practice for valuing securities of the type in question. (As with the MRA, negotiated annexes may modify the standard definition and may give the buyer discretion to determine pricing sources.) However, the GMRA has a more streamlined and buyer-friendly definition of "default market value" for use in liquidation after an event of default, as discussed below.

Unlike ISDA swap agreements, the MRA and the GMRA do not contain dispute resolution provisions for margin calls or provide for the transfer of undisputed portions of margin calls as credit support. In the event of a dispute, a challenge to a margin call applies to the margin call in its entirety.

The Next Step: Events of Default or Termination Events

The failure to satisfy a margin call can give rise to an event of default and termination right under the applicable ISDA master agreement or an event of default and acceleration right under the repurchase agreement (whether documented under the MRA or GMRA). In addition, the very circumstances that give rise to a margin call may also give right to a termination right – e.g., as to NAV or insolvency triggers – even if evolving margin requirements are satisfied.

Overview of Events of Default or Termination Events

Events of default in the ISDA master agreement permit the non-defaulting party to terminate all transactions, while termination events permit the non-affected party to terminate all affected transactions. Events of default under the ISDA master agreement consist of failure to make a required payment or delivery following the applicable grace period (one business day under the 2002 ISDA master agreement and 3 business days under the 1992 ISDA master agreement), breach or repudiation of the contract, credit support default (including a failed margin call on

collateral), misrepresentation, default under other qualified financial contracts (with a broader scope of coverage in the 2002 ISDA master agreement than in the 1992 ISDA master agreement), cross-default to borrowed money, bankruptcy or insolvency (discussed below), and merger without assumption of the transactions by the succeeding or surviving entity. Termination events include illegality (i.e. an affected transaction becoming illegal for either party under applicable law), a "force majeure event" (in the 2002 ISDA master agreement only), or a tax event, tax event upon merger or credit event upon merger, in addition to any agreed additional termination events, which is where NAV triggers at the entity level are normally addressed.

Events of default in the MRA and the GMRA permit the non-defaulting party at its option to accelerate the repurchase date Events of default include (i) failure to transfer or purchase repo'd assets on the purchase date or the repurchase date as applicable,[6] (ii) failure to comply with the margin requirements in Paragraph 4 of the MRA or GMRA, (iii) the buyer's (and in the GMRA, the seller's) failure to transfer income payments after one business day notice, (iv) an act of insolvency (discussed below), (v) misrepresentation, or (vi) a party's admission to the other its inability to, or its intention not to, perform any of its obligations thereunder. In addition, the GMRA provides that an event of default occurs if (vii) a party is declared in default or being suspended or expelled from membership of, or participation in, any securities exchange or is suspended or prohibited from dealing in securities,[7] or (viii) a party breaches any other obligation under the GMRA that is not remedied within 30 days, after notice of same.

Solvency Considerations

NAV maintenance covenants in the contract in question may be particularly important in stressed market conditions, as the failure to satisfy required asset levels may result in a termination event under a swap or an event of default under an MRA or GMRA. NAV covenants are typically set forth in negotiated ISDA schedules or MRA or GMRA annexes, and may consist of both required minimum NAV levels, and negative covenants against specified percentage declines in NAV (e.g., over the prior month, quarter, year or other measurement period).

In addition, specified insolvency events are events of default for swaps and repos: defined as "bankruptcy" events in the ISDA master agreement, and "acts of insolvency" in the MRA and GMRA. These encompass formal bankruptcy, administration, receivership, resolution or similar legal proceedings (voluntary or involuntary) against a counterparty or a credit support provider, but also contain a subtle difference between the older and new versions of the agreements. While all of the agreements include as bankruptcy or insolvency events a party's admission in writing of its inability to pay its debts as they become due, the newer versions of the standard contracts (i.e. the 2002 ISDA and the 2011 GMRA) add objective insolvency to the list: either becoming "insolvent" or being unable to pay one's debts, regardless of whether an admission is

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[6] Under either GMRA, if the buyer fails to transfer repo'd assets to the seller on the agreed close-out date of a transaction, i.e. the "repurchase date", the seller may elect to exercise a cash-settled 'mini close-out' of that transaction. Under that procedure the buyer must pay an amount equal to the difference between the "repurchase price" and the "default market value" of the repo'd assets, sparing the seller of the need to buy-in an alternative source of supply or declare a broader event of default.

[7] The 2011 GMRA adds that such default, suspension or expulsion must be on the grounds that a party has failed to meet any requirements relating to financial resources or credit rating.

made. The standard forms of contract do not define the term "insolvent," so there may be some leeway for determining whether an insolvency has actually occurred.[8]

Insolvency is typically determined on a balance sheet basis (assets less liabilities), but may also be determined on a cash flow basis (inability to pay debts as they become due) or an undercapitalization basis (insufficient assets for contemplated business plans). This may pose significant practical challenges for a fund facing margin calls, because it may be solvent on a balance sheet basis but also "cash flow insolvent" if its holdings consist primarily of illiquid assets and it is facing constrained credit markets for new funding. The flip side is also true: an enforcing counterparty may face pushback, and possible litigation, if it interprets the insolvency trigger too aggressively while a fund shows other signs of financial health and the ability to weather a liquidity crisis.

Is Force Majeure or Illegality a Defense to Enforcement?

There has been much discussion generally regarding whether the financial disruptions attendant to the COVID-19 pandemic constitute force majeure or illegality in various contexts.[9] This issue is relevant to swaps as it raises the question of whether a termination event may exist for "illegality" or (in the 2002 ISDA master agreement) a "force majeure event." The answer depends to an extent on the type of transaction and the underlying documentation.

Under the 2002 ISDA Master Agreement

Under the 2002 ISDA master agreement, a "force majeure event" arises if by reason of force majeure or act of state occurring after a transaction is entered into (i) the office through which a party makes and receives payments or deliveries with respect to a transaction is prevented from making or receiving a payment or delivery in respect of such transaction or from complying with any other material provision of the agreement or it becomes impossible or impracticable for such office to so perform or comply; or (ii) a party or its credit support provider is prevented from making or receiving a payment or delivery under a credit support document relating to such transaction or from complying with any other material provision of such credit support document, or it becomes impossible or impracticable for such party or credit support provider to so perform or comply.

The concept of force majeure in the 2002 ISDA master agreement is different than it is in other contexts because it does not excuse the affected party from performing its obligations under the contract but actually permits the other side to terminate affected transactions. However, "illegality" and a "force majeure event" under the first prong described above does provide the affected party with the benefit of a waiting period during which the ability to terminate affected transactions is deferred. Upon the occurrence of an "illegality" or a "force majeure event," a temporary standstill generally applies to affected transactions for the duration of a "waiting

[8] Under bank resolution rules in several jurisdictions, counterparties to swaps, repos and other qualified financial contracts with global systematically important banks ("GSIBs") and their subsidiaries or affiliates ("covered entities") must agree to contractual limitations on their ability to exercise direct default rights against a GSIB that is in a resolution proceeding and from exercising cross-default rights against covered entities that may arise because a credit support party is subject to resolution. See, e.g. Federal Reserve Rule YY (12 CFR Part 252); UK Banking Act 2009. These do not affect the exercise of insolvency-related rights against a counterparty that is not a GSIB or a covered entity.

[9] For a general discussion of force majeure clauses in the United States in the context of COVID-19, see our client alert: http://www.klgates.com/covid-19-applicability-of-force-majeure-clauses-in-the-us-03-18-2020/.

period," assuming the problematic event or circumstance persists. In the case of "illegality," the waiting period is three local business days (or days that would have been local business days but for the occurrence of the relevant event or circumstance) following the occurrence of the event or circumstance.

In the case of a "force majeure event" that affects performance under a 2002 ISDA master agreement, the waiting period is eight local business days. However, no waiting period applies in transactions where the problematic event or circumstance affects a payment or delivery under, or compliance with, a NY CSA or with other credit support documents that are not integral parts of the ISDA master agreement. On the other hand, this restriction should not apply to transactions that are subject to an English CSA to the extent the English CSA is considered to arise under the ISDA master agreement and collateral movements to represent transactions under the ISDA master agreement.

An event or circumstance that constitutes or gives rise to an "illegality" or a "force majeure event" will not, for so long as that is the case, also constitute or give rise to an event of default for failure to pay or deliver, breach of obligation or a credit support default under the ISDA master agreement. Instead, this type of event constitutes a "termination event" that gives a counterparty an option to terminate after an applicable notice-and-cure period, unless contrary provisions are negotiated in the schedule to the ISDA master agreement.

It is unlikely that the COVID-19 crisis will trigger a termination event for "illegality" or for a "force majeure event" in cash-settled swap transactions referencing or secured by financial assets for so long as the relevant markets, payment channels and the clearing systems remain open and custodians, dealers or other intermediaries remain operational. One key issue may be whether a party is unable to make payments or deliveries through an office because of stay-at-home orders or advisories issued by an appropriate governmental authority. Another will be whether rights arise exclusively under the ISDA master agreement or under separate agreements, and the governing law of the ISDA master agreement and the CSA may be determinative.

Under the 1992 ISDA Master Agreement, MRA and GMRA

Force majeure and act of state concepts do not explicitly apply under the 1992 ISDA master agreement, the MRA or the GMRA unless added to the agreement in the negotiated schedule or annex. Therefore, these types of agreements may give rise to defenses based upon common-law concepts of force majeure that applies more generally in the contract law that governs the transaction in question.[10]

The Next-to-Last Step: Calculating Net Amounts Due

Enforcement rights are affected by the measure of the amount owed (the exposure) and the value of the collateral. This depends in part on the nature of the instrument in question.

Swaps

In the case of a swap, the exposure is based on the early termination amount for the transaction in question, which in turn depends on whether the transaction is documented under the 1992 ISDA master agreement or the 2002 ISDA master agreement.

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[10] The User's Guide to the 1992 ISDA master agreement contains an optional "impossibility" provision that is sometimes added to transactions documented on that form of ISDA master agreement.

Under the 2002 ISDA master agreement, valuations are based on a single payment measure, known as the "close-out amount." This amount represents the amount of the losses or costs that the determining party would incur (or the gains it would realize) in replacing or providing the economic equivalent of the material terms of the transactions if they were terminated. This essentially requires a mark-to-market methodology with discretion by the determining party. The 2002 ISDA master agreement requires the determining party to act in good faith and to use commercially reasonable procedures when determining a close-out amount in order to produce a commercially reasonable result.

Under the 1992 ISDA Master Agreement, the early termination amount may be based upon either "loss" or "market quotation". If the parties do not select a payment measure in the schedule, the applicable payment measure will be "market quotation," although "loss" remains a fallback provision in the event a market value cannot be determined or (in the reasonable belief of the party making the determination) would not produce a commercially reasonable result. "Market quotation" is a payment measure determined on the basis of quotations from leading dealers in the relevant market selected by the party determining the valuation, while "loss" is a payment measure in which a party reasonably determines in good faith its total losses (expressed as a positive number) and gains (expressed as a negative number) in connection with transactions under a 1992 ISDA master agreement. If there are no real bids in an illiquid market, a question arises whether the amount of the exposure (and the calculation of a surplus or deficiency) has been calculated in a commercially reasonable manner.

To the extent that a swap transaction is subject to the uncleared swap margin rules, the main focus of attention in a close-out scenario will be the determination of the exposure, i.e. the value of the swap transaction itself, since the collateral will consist of cash and cash equivalents.

Repurchase Transactions

In the case of repurchase agreements documented under the MRA or the GMRA, the transaction exposure is based on the repurchase price, which represents a fixed dollar amount equal to the purchase price funded up-front plus the agreed price differential (which is like interest on the purchase price); in that sense, the exposure under a repurchase agreement is similar to the principal amount of a secured loan plus accrued interest.

The MRA provides that if the non-defaulting party is the buyer, it may elect either to sell the repo'd assets and apply the proceeds to the repurchase price, plus other amounts due under the MRA and collection costs, or instead value the repo'd assets based on market price quotes and credit that valuation against the total amount due, with an unsecured claim against the seller for any deficiency. If the non-defaulting party is the seller, it may elect either to purchase replacement assets or to deem itself to have made such a purchase based on market price quotes, and then make a claim for any excess price paid (or deemed paid), plus any other amounts due from the buyer under the MRA and collection costs.

Once a GMRA party is formally in default, the process of close-out starts. This has three stages.

1. Acceleration of all outstanding payment obligations;
2. Determination of "default market values" of collateral and addition of transaction costs; and

3. Conversion of all sums due into the "base currency" specified in the annex and payment of the net amount by the relevant party as permitted under English law, including the UK Insolvency Act 1986.

In determining the "default market value" of repo'd assets under English law, the GMRA provides the calculating party with three sequential valuation methodology options:

A. The first potential valuation method allows the non-defaulting party to elect to use actual sale or purchase prices in respect of collateral sold as a basis for the determination of the Default Market Value. Under English law, there is no requirement that the party achieve a certain price and the seller is generally allowed to achieve whatever price is available to it given the market conditions prevailing.

B. The second valuation method allows the non-defaulting party to elect to reference received bid or offer quotations from at least two market makers as a basis for the determination of the Default Market Value.

C. The third valuation method, which applies if methods one and two above have failed, allows the non-defaulting party to determine the market value of the collateral using its own methodology albeit acting in good faith. However, as noted above, such good faith extends only to ascertaining a reasonable price payable having regards to the prevailing circumstances.

The Last Step: Liquidating Collateral

New York and U.S. Bankruptcy Law

In the event of termination – including if a margin call cannot be met by a counterparty's posting of additional cash or collateral – the secured party may liquidate swap or repo collateral consistent with the applicable provisions of the particular swap or repo contract at issue.

For swaps and repurchase transactions governed by New York law, the liquidation of collateral must comply with the New York Uniform Commercial Code (the "UCC"), which imposes a standard of "commercial reasonableness" on collateral dispositions.[11] Specifically, the UCC requires that "[e]very aspect of a disposition of collateral, including the method, manner, time, place, and other terms, must be commercially reasonable."[12]

This does not, however, mean that every aspect of a liquidation can automatically be questioned after the fact with the benefit of 20/20 hindsight. The UCC expressly provides, for example, that "[t]he fact that a better price could have been obtained by a sale at a different time or in a different method from that selected by the secured party is not of itself sufficient to establish that the sale was not made in a commercially reasonable manner."[13] Further, the UCC identifies certain instances of commercially reasonable collateral dispositions, including where the

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[11] See generally N.Y. UCC § 9-610.

[12] Id. at § 9-610(b).

[13] Id. at § 9-627(a); see also *DeRosa v. Chase Manhattan Mortgage Corp.*, 10 A.D.3d 317, 322 (1st Dep't 2004). As discussed further below, the U.S. Bankruptcy Code also incorporates this concept into its "self-help" safe harbors. See 11 U.S.C. § 562(a); *In re American Home Mortg. Holdings, Inc.*, 637 F.3d 246 (3d Cir. 2011) (finding that a discounted cash flow analysis was a "commercially reasonable determinant of value" for measuring amounts owed under a repo contract under Bankruptcy Code § 562(a)).

disposition occurs "in the usual manner on any recognized market" or "at the price current in any recognized market at the time of disposition," among others.[14]

Because the UCC's defined instances of commercial reasonableness often rely on "recognized markets," disputes over the commercial reasonableness of a collateral disposition have often arisen where the market for the underlying collateral is illiquid or otherwise alleged to be disrupted; as such, these cases may have particular relevance to collateral dispositions in the context of the market volatility caused by the COVID-19 pandemic.

For example, in *In re HomeBanc Mortgage Corp*., the trustee of a bankrupt mortgage lender sued the lender's repo counter-party, Bear Stearns, claiming that Bear Stearns liquidated certain MBS in August 2007 in a manner that was not commercially reasonable, in violation of the parties' MRA and GMRA.[15] Among other things, the trustee argued that there was "no market" for the MBS at issue at the time and thus a discounted cash-flow model was the only reasonable way to value the assets.[16] After trial, the Bankruptcy Court for the District of Delaware rejected that argument, finding that, in conducting a bids-wanted-in-competition auction despite the "difficult, but functioning, market" for MBS at the time, Bear Stearns acted commercially reasonably.[17] In another MBS decision, however, the lack of market pricing indicia on the date of default proved fatal to a repo party's attempted liquidation of collateral.[18]

In the event a defaulting counterparty has filed for bankruptcy, various U.S. statutory safe harbors generally permit the non-defaulting party to proceed to termination and liquidation notwithstanding the commencement of bankruptcy or insolvency proceedings and any resulting automatic stay beyond a minimal period in some cases. These are set forth in several provisions of the U.S. Bankruptcy Code, for swaps, repurchase agreements or securities contracts (both of which can be documented as a repo under the MRA and GMRA), other types of financial contracts, and related netting agreements.[19] Parallel safe harbors apply if the counterparty is an insured financial institution[20] or a registered broker-dealer.[21] Case law has imposed some limitations on the exercise of safe harbor self-help remedies, however. Some U.S. courts have required them to be exercised promptly.[22] Others have limited safe harbor setoff to pre-

14 Id. at § 9-627(b)-(c).

15 573 B.R. 495 (Bankr. D. Del. 2017), aff'd, 590 B.R. 69 (D. Del. 2018), aff'd, 945 F.3d 801 (3d Cir. 2019).

16 Id. at 504.

17 Id. at 522.

18 See *Sher v. RBC Capital Markets, LLC*, 539 B.R. 260 (D. Md. 2015) (finding that repo buyer's liquidation of collateral using an auction process three days after the default date breached the parties' MRA and that the repo buyer's own trading desk valuation on the day of default was the proper measure of damages, thereby awarding the repo seller US$26.2 million, plus interest, representing the difference between the amount the repo buyer accepted at auction three days after the default date and its own trading desk valuation as of the default date). This case subsequently settled on appeal to the Fourth Circuit Court of Appeals.

19 See 11 U.S.C. §§ 555-556, 559-562; id. at §§ 362(b)(6), (7), (17) and (27); id. at § 362(o).

20 See 12 U.S.C. § 1821(e)(8). These safe harbors are subject to an initial one-business day stay.

21 See 15 U.S.C. § 78eee(b)(2)(C). These safe harbors are usually subject to an initial 21-day stay.

22 See *In re Lehman Brothers Holdings Inc.* ("*Metavante*"), bench ruling issued in Case No. 08-13555, Dkt. No. 5261 at 101-113 (Bankr. S.D.N.Y. September 17, 2009) (a swap counterparty must exercise termination rights promptly or risk losing them; if it is out-of-the-money at the time of the bankruptcy filing, it cannot cease making required swap payments and then exercise its termination rights later (post-petition) once it was in-the-money);

bankruptcy debts only (i.e., imposing a U.S. bankruptcy requirement of "mutuality"),[23] or limited setoff and netting to debts that are expressly related to the underlying swap or repo contracts.[24]

Under U.S. bankruptcy law, any deficiencies after the exercise of self-help safe harbor remedies may be asserted as an unsecured claim in the defaulting counterparty's bankruptcy proceeding.

English Law

English courts give disposers of collateral considerable leeway in the manner in which they determine the disposal value of collateral, so whilst a good faith standard exists and has been adhered to in practice, there is little practical scope for defaulting party challenges to the price achieved.

In the event a defaulting counterparty is insolvent, English insolvency law provides that the prior posting of collateral under a CSA or pursuant to the terms of a GMRA was an outright transfer of such collateral. Those amounts are due for "re-transfer" upon termination of the ISDA Master Agreement or the GMRA, but are then also subject to close-out netting. Close-out netting is specifically permitted by the Insolvency Act 1986, meaning that any collateral held will be converted into an "unpaid amount" and the collateral taker will be required to return only the amount by which the collateral held by it exceeds any close-out amount due to it. To the extent that the value of the collateral is less than the close-out amount due to a collateral taker, it may file a claim in the insolvency of the counterparty for such net amount, with such claim being treated as an unsecured claim that ranks pari passu with all other unsecured creditors.

Conclusion

The COVID-19 crisis has destabilized financial markets and financial assets in ways not seen since the fall of Lehman and the rescue of AIG in 2008. End-users with exposure to those markets and assets through qualified financial contracts such as swaps and repos must grapple with potentially existential valuation marks and collateral calls. In such potentially dire circumstances some areas of ambiguity in the industry-standard forms of contract may offer room for maneuver.

Chief among these are how "market value" is determined – for purposes of both margin calls and determining liquidation values – and whether an NAV trigger or insolvency event has actually

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Amcor Funding Corp., 117 B.R. 549 (D. Ariz. 1990) (liquidating broker could not use the securities contract safe harbor to liquidate the debtor's margin account one year after its Chapter 11 filing). But see *In re Southern California Edison Company*, 2018 WL 949223 (S.D. Tex. Feb. 15, 2018) (rejecting "promptness" requirement for party continuing to perform post-petition).

[23] See *In re Lehman Brothers Holdings Inc.* ("*Swedbank*"), 433 B.R. 101 (Bankr. S.D.N.Y. 2010), affirmed, 445 B.R. 130 (S.D.N.Y. 2011), appeal to Second Circuit dismissed, case settled (2d Cir. Apr. 6, 2011). In *Swedbank*, the bankruptcy court ruled that a bank could not set off a post-petition debt (a bank deposit) against a pre-petition swap debt, finding that the safe harbors were subject to the "mutuality" requirement of § 553 of the Bankruptcy Code. The parties settled on appeal.

[24] See *In re Lehman Brothers Holdings Inc*. ("Bank of America"), 439 B.R. 811 (Bankr. S.D.N.Y. 2010), appeal to S.D.N.Y. dismissed, case settled in Case No. 08-13555, Dkt. 21030 (Bankr. S.D.N.Y. Oct. 19, 2011). In B*ank of America*, the bankruptcy court ruled that a bank could not set off amounts in a deposit account (a debt it owed Lehman) against amounts Lehman owed under a swap agreement, because the bank's security rights against the account were not "contractual rights" related to the swap. The parties settled on appeal.

happened. A principal issue is how and when a party sourced its market quotes and whether its methods were commercially reasonable, particularly in volatile or illiquid markets – although the negotiated ISDA schedules or repo annexes are often carefully drafted to try to get around this problem, by vesting greater discretion in the secured party or repo buyer. Similarly, NAV triggers and other additional "termination events" are often carefully drafted in schedules and annexes, but often vary among counterparties based on their own forms. The exact language must be consulted for each counterparty, to determine how these triggers are measured and when.

Finally, whether a party is "insolvent" – specifically, on what basis (e.g., balance sheet? cash flow? undercapitalization in light of current business plans?) – or "unable to pay its debts" (e.g., as of when? after a grace period or forbearance?), may give rise to a lively debate in the context of threatened margin calls or accelerations.

Even if the party calling margin may have the power to impose its marks and exercise termination rights, the considerations described above may have continuing sway in litigation over whether such actions were commercially reasonable. Exposure to potential monetary damages and reputational harm in litigation arising from after-the-fact interpretations of gray zones of industry practice may lead some such parties to consider treading carefully, lest an aggressive posture during the COVID-19 crisis may be second-guessed later on, either in court or as a reputational matter.

May 13, 2020

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