Margin Call Disputes: Key Issues for Investors Under English Law

I. Introduction

Driven by the Coronavirus pandemic, extreme volatility on the financial markets in early 2020 led to lenders and financial institution counterparties issuing a significantly increased number of margin calls under facilities governed by English law. Due to the rapid devaluation in the collateral held under such facilities, including margin lending facilities and ISDA-governed transactions, these margin calls typically demanded significant amounts of cash or additional collateral within a very short space of time, in order to cover a lender's or counterparty's exposure. As happened in the 2008 financial crisis, this environment has led to disputes crystallising over the validity of these margin calls, collateral valuations, the validity of parties' acceleration and termination rights for missed margin calls, and the sale of collateral in enforcement actions.

Nine months on from the extreme volatility which drove the margin calls and subsequent enforcement actions by lenders that have since been called into question, this Client Alert considers the key litigation issues that investors are now facing in such disputes. We are already seeing the first of these claims being filed against institutional investment banks.[1] Accordingly, this Client Alert considers:

- ways in which margin calls, valuations, and the sale of collateral may be challenged (and defended);
- practical points of litigation strategy that arise in such disputes; and
- the remedies open to investors when the counterparty wrongfully terminates the relevant agreements, including for the alleged non-payment of a margin call and/or disputing a collateral valuation.

II. What is a margin call?

A margin call is where one party is required to post additional cash or securities (the 'margin') on demand (the 'call') to cover the counterparty's exposure to changes in the value of an underlying, in circumstances where the terms of the parties' relationship requires that such exposure should remain collateralised within contractually pre-determined levels.

III. In what context do margin call disputes arise?

One of the most common types of transaction in which margin calls are made is when a lender and a borrower enter into a margin lending facility. Under such facilities, the lender agrees to lend to the borrower against the value of shares or debt securities deposited with the lender as collateral. This enables leveraged lending, whereby the loan is given against the value of existing investments.

Such facilities typically contain loan-to-value ("LTV") ratio triggers. Once the value of the underlying collateral falls past one of these LTV triggers, the lender is entitled to make a margin call against the borrower, in order to account for the falling value of the security it holds. As the value of the collateral decreases, the amount of each margin call by the lender against the borrower will accordingly increase. This form of lending therefore directly exposes the borrower to sudden movements in equity and debt markets, as the borrower is 'on the hook' to account for falling valuations.

[1] *Blue Sky Equity Trading LLP v Credit Suisse (UK) Limited*, CL-2020-000655 (filed 6 October 2020).

Margin calls are also used in more complex transactions governed by ISDA Master Agreements that elect to use the Credit Support Annex. The most common type of Credit Support Annex is the 1995 version ("1995 CSA"). In 2016, ISDA updated and released a new 'Credit Support Annex (Variation Margin)', or 'VM' ("CSA (VM)"). This newer CSA (VM) does not have retrospective effect, and so many open trades are still governed by the 1995 CSA. While there are some differences between the two CSAs, for present purposes the core obligations on the Valuation Agent effectively remain the same. Terms used in this Client Alert, but that are not otherwise defined, take their meaning from the standard-form CSA (VM).

Either form of CSA enables the parties to exchange collateral, with the typical intention being to collateralise the credit risk of the investor, thereby protecting the institutional counterparty in its dealings with the investor. The quantum of the collateral that is exchanged is linked to each party's exposure to the underlying positions that have been taken in the relevant trades. Unless agreed otherwise, the collateral is delivered to the party that is 'in the money' on the underlying positions. The delivery of the collateral therefore mitigates the credit risk of the counterparty if a close-out is called, but it cannot make full payment. As with other forms of transactions that use margin calls, market volatility can lead to large increases in the amount of collateral demanded, particularly by institutional lenders.

IV. Key ways for investors to challenge margin calls

The following four areas are the ones that typically give rise to margin call disputes.

(1) Disputing a margin call's validity

The first way to challenge a margin call is to dispute its validity on the basis that contractual provisions relating to the margin call process have not been followed. For investors, the starting point in any such challenge is ascertaining the facts relating to the margin call in question, including taking copies of the email or other form of communication making the margin call (including recorded telephone discussions) and mapping out the contractual time periods that need to be complied with by both parties. A preliminary analysis on whether these time limits have, in fact, been complied with is likely to be useful in these initial stages.

In assessing the validity of a margin call after the fact, English courts will always begin by construing the terms of the relevant agreements.[2] Under ISDA and non-ISDA transactions alike, the relevant provisions (particularly those on notice) should be carefully examined to determine whether the margin call was made in accordance with the process set out in the contract. If the contract has not been complied with, there may be a *prima facie* argument that the margin call was invalid. Existing case law on margin calls in the 'spread betting' context reinforces that the contractual process must be followed; in those cases, there was a "*minimum content*" required for a valid margin call.[3]

However, as regards ISDA-governed transactions, the position may be different. As discussed further below, under a CSA, the Valuation Agent has a duty to perform its valuation obligations "*in good faith and in a commercially reasonable manner*".[4] In the leading English case, the Commercial Court found that Deutsche Bank's failure to perform its obligations in this manner for two out of five margin calls did *not* render those two calls invalid.[5] Mr. Justice Cooke found that "*Paragraph 9(b) cannot be read as a condition*

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2 *Wood v Capita Insurance Services Limited* [2017] 2 WLR 1095.

3 *Spreadex Limited v Sekhom* [2008] EWHC 1136 (Ch) at [88].

4 Paragraph 9(b), 1995 CSA and CSA (VM).

5 *Deutsche Bank AG v Sebastian Holdings Inc* [2013] EWHC 3463 (Comm) *("**Sebastian Holdings**").

precedent to the validity of a margin call".[6] Accordingly, a breach of the Valuation Agent's valuation obligations will not necessarily render a margin call invalid. However, several points can made in this connection:-

- Mr. Justice Cooke went on to say that despite his construction of Paragraph 9(b), to "*the extent that there is any breach, damages would follow, if any were suffered*".[7] It follows the relevant question is whether the investor has suffered loss. Although an investor may face difficulties proving loss unless there is clear evidence that the funds used to meet the margin call would otherwise have made a profitable investment, nonetheless an investor may still claim damages for any margin calls made in breach of Paragraph 9(b) if loss has been suffered. If the institutional counterparty has not terminated the ISDA facility, the investor's claim may therefore simply be a standalone breach of contract claim for investment losses, while the trading relationship otherwise continues.

- The same point applies if an investor has suffered losses due to the wrongful termination of an ISDA facility, in circumstances where an institutional counterparty asserts a margin call has been missed. If that margin call was invalidly made in breach of contract, the breach will infect any subsequent acceleration or termination by the counterparty – meaning an investor may be able to claim its forward-looking losses.

- In any event, *Sebastian Holdings* (2013) was decided before the Supreme Court's decision in *Braganza* (2016, see further below). Accordingly, while the institutional counterparty who has made the margin call will likely take *Sebastian Holdings* as a starting point, there may nonetheless be scope for an investor to advance cogent arguments to the contrary.

Accordingly, it will generally be more difficult to challenge the validity of a margin call itself under CSAs. However, a key way investors can challenge ISDA margin calls is by proving that the counterparty did not comply with its hard-edged **notice obligations** under Section 12 of the ISDA Master Agreement. Demands under a CSA or CSA (VM) ***must*** comply with those overarching requirements, unless they have otherwise been modified by the parties. The notice provisions in the ISDA Master Agreement are generally more tightly construed than in other types of contracts.[8] Outside of the ISDA case law, it is in any event an established principle that any mandatory requirements for the service of notices be strictly complied with.[9] As such, there is clear scope to challenge a collateral call that has been made in breach of the contractual notice provisions.

The consequences of an invalid margin call depend on what has happened following the call being made. During a live dispute, an investor may simply wish to write to the counterparty and request that it re-issue the margin call in accordance with the terms of the relevant facility. If, however, the counterparty has accelerated or terminated the facility on the basis that an invalid margin call has (allegedly) not been satisfied by an investor, that investor may have a claim for wrongful termination, including for forward-looking expectation damages. We consider the possibility of such claims in further detail below.

Finally, we note that margin call disputes often involve a succession of cumulative, increasing margin calls. An important point is that the English courts have found that, in the ISDA context, it is the original call that stands to be satisfied: it is not superseded or extinguished by those calls that follow it.[10] While in practice this may mean that an investor is liable to meet the full, cumulative amount of the margin

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[6] *Sebastian Holdings* at [1153].

[7] *Sebastian Holdings* at [1153].

[8] *Greenclose Ltd v National Westminster Bank Plc* [2014] 2 BCLC 486 at [36] and [121].

[9] *Mannai Investment Co Ltd v Eagle Start Life Assurance Co* [1997] AC 749 at 776 per Lord Hoffmann.

[10] *Goldman Sachs v Videocon Global Ltd* [2013] EWHC 2843 (Comm).

calls when they remain outstanding, this case law has an important effect on the timing of meeting such calls. To illustrate this, one may posit a scenario where two margin calls have been made, one day after the other. If the first margin call is paid in time (usually one or two business days following the first call), then the institutional counterparty cannot designate a close-out until *after* the time the second margin call is missed. Once the first is paid, the investor's liability is only for the amount of the second margin call. Any early termination may be wrongful, enabling an investor to make a claim (see further below).

(2) Disputing collateral valuations

In fast moving markets, investors and counterparties may wish to challenge the valuation of collateral by the party making the margin call.

In situations where the collateral is **liquid**, such as commonly-held shares traded on stock market exchanges, this valuation should be capable of being objectively verified by reference to the relevant trading price of the collateral. For example, Bloomberg may be used to verify the price. Regardless of whether a challenge is sought to be made at the time of the call or after the fact, the valuation in either case should be capable of relatively straightforward verification by reference to the market price. Despite this, any challenge should pay close attention to any qualifications on the collateral-taker's valuation right, most importantly in relation to whether the investor needs to be notified of the source of the valuation.

Where the collateral is **illiquid**, however, there is a wider scope to challenge the collateral-taker's valuation. This is due to the fact that there may be a range of reasonable market valuations of the collateral, but a counterparty may attempt to exploit this by valuing it below the floor of that acceptable market range. Illiquid collateral may comprise shares in privately-held companies, structured credit products, options or real estate positions. In such circumstances, the following are ways to challenge the valuation of the illiquid collateral:-

- Under non-ISDA facilities, bringing a claim for breach of any relevant obligations by the lender to obtain proper market quotations from dealers for the collateral.

- If under ISDA, bringing a claim for breach of the counterparty's express obligation to act in good faith and in a commercially reasonable manner (see further below).[11]

- Under non-ISDA and ISDA facilities, bringing a claim that the counterparty has breached an implied term that it would not perform its valuation obligations arbitrarily, capriciously or unreasonably.[12]

Illiquidity in ISDA-governed transactions – disputing exposure valuations

Valuations under ISDA-governed facilities may also give rise to disputes where it is not the collateral itself that is illiquid, but rather where the **illiquidity lies in the underlying trades themselves**. Collateral valuations under a CSA and CSA (VM) are both **linked to the exposure** arising from the underlying trades, such that the party that is 'in the money' on those trades will typically be entitled to demand additional collateral to mitigate its counterparty's credit risk.

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[11] Paragraph 9(b) of the 1995 CSA and CSA (VM).

[12] *Socimer International Bank Ltd v Standard Bank London Ltd* [2008] 1 Lloyd's Rep. 558 at 578. See also *Barclays Bank Plc v Unicredit Bank AG* [2012] EWHC 3655 (Comm) at [63] per Popplewell J. The existence of this fetter on the Valuation Agent's discretion appears to have been assumed in the *Sebastian Holdings* case at [1152] per Cooke J. See also *Compass Group UK and Ireland Ltd (t/a Medirest) v Mid Essex Hospital Services NHS Trust* [2013] B.L.R. 265 at [83] on the difficulty of attempting to exclude this implied term through the parties' agreement. However, *cf TAQA Bratani Limited v Rockrose UKC58 LLC* [2020] EWHC 58 (Comm) at [46] per Blair J.

Accordingly, when the underlying trades are, for example, structured credit positions, it is the valuation of ***those*** positions that may give rise to a dispute. Given that one of the parties to the transaction will typically be the designated Valuation Agent, this creates fertile ground for disputes – especially when the Valuation Agent is permitted to have regard to its own commercial interests in arriving at its valuation.

These sorts of valuation disputes often arise due to a lack of mark-to-market valuations for the reference assets used in credit derivative products. At times of extreme market volatility, such as that in March 2020, investors may have considered that investment banks and other institutional counterparties made repeated adverse collateral calls for ulterior purposes, including in order to increase their overnight liquidity illegitimately. By exploiting the lack of marks against which to value the reference assets, the counterparty may have inflated the amount of collateral demanded.

As a practical step in any live dispute, if a collateral call is based on a dubious valuation, the investor should **send a letter disputing the valuation and reserving its rights**. Care should be taken to avoid this letter (or email) from being construed as a repudiation of the transaction by the investor, and express wording to this effect should be included.[13] Such a letter or email should ensure there is an evidentiary record to demonstrate that the counterparty has been put clearly on notice of its contractual obligations as the Valuation Agent.

In making a valuation for the purposes of a collateral call under either form of CSA, a Valuation Agent has various linked discretions. Most importantly, it is required to determine Exposure, the Delivery Amount (1995 CSA), Delivery Amount (VM) and Value. In doing so, the Valuation Agent has an overriding contractual duty to perform these obligations in "***good faith and in a commercially reasonable manner***".[14] This obligation is expressly stated to include any "*calculation, valuation or determination*" the Valuation Agent is required to make.[15]

This is the contractual 'hook' that provides scope for investors to challenge valuations, by bringing a claim for breach of contract. The question then becomes: what does this obligation to act in "*good faith*" and "*in a commercially reasonable manner*" mean?

Express term: good faith and commercially reasonable manner

The findings of *Sebastian Holdings* provide valuable guidance, as it is the only reported English case to consider the scope of this express contractual obligation under ISDA. It is important to note that the Commercial Court found this express obligation is divided into two halves, with one (the obligation to act in good faith) imposing a **subjective test**, and the other (the obligation to act in a commercially reasonable manner) imposing an **objective test** of conduct.[16]

In *Sebastian Holdings*, the two margin calls in question **failed** the objective test of conduct. The Court found that the "*extent of the mistakes and omissions made in those two calls is breathtaking*".[17] This was because it was "*impossible*" for Deutsche Bank, when making the call, to have made proper margin calculations in a commercially reasonable manner, due to "*deficiencies in [its] systems*" and "*the peculiarities of particular trades*".[18]

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13 This includes by reference to Section 5(a)(iii)(3) of the ISDA Master Agreement.
14 Paragraph 9(b) of the 1995 CSA and CSA (VM).
15 Paragraph 9(b) of the 1995 CSA and CSA (VM).
16 *Sebastian Holdings* at [1153] per Cooke J.
17 *Sebastian Holdings* at [1197] per Cooke J.
18 *Sebastian Holdings* at [1201] per Cooke J.

Looking at each of the two margin calls:-

- For the **first call**, no mark-to-market valuation had been included in the margin amount for almost all of the outstanding target profit forwards, nor had any liquidity add-on been included.[19]

- For the **second call**, part of the mark-to-market valuation consisted only of the individual trader's apparently manual "*estimate of intrinsic values*", with some limited cross-checking to system values.[20] Moreover, it included no VaR in respect of certain indirect outstanding target profit forwards and, again, no liquidity add-on had been included.

In light of these issues, the proper course for Deutsche Bank when making the call was for it to "*produce figures by reference to the best available information*" with a "*view to sitting down and negotiating sensible margin figures*".[21] The case highlights the features of a deficient margin valuation which will render it in breach of the Valuation Agent's Paragraph 9(b) commercially reasonable manner obligation (noting the finding, as discussed above, that such breach will not necessarily be a condition precedent to the validity of a margin call).

It follows that the core of any challenge to an adverse valuation should allege the Valuation Agent has **objectively breached its express obligation** to make the relevant calculations and valuation in a commercially reasonable manner. As indicated by the *Sebastian Holdings* case, the English courts will evaluate the methodology used by the counterparty, including any pricing inputs for the trades and applicable practices in the relevant market. Accordingly, this will typically require expert valuation evidence to prove that the counterparty's valuation falls short of this standard.

Finally, we note that in any live dispute under ISDA, there is a mandatory dispute resolution regime which the parties must follow, unless otherwise agreed.[22] Claims after the fact may still be brought even if this dispute resolution process was not engaged at the relevant time.

(3) Acceleration and termination rights for missed margin calls

If a margin call is missed, then this will usually trigger acceleration or termination rights in favour of the counterparty or lender. As noted above, if, in a live dispute, an investor wishes to dispute the validity of the call and/or its valuation of the collateral or underlying trades, it should send a letter reserving the investor's rights before the time for payment falls due. Under the ISDA framework, it should also engage in the prescribed dispute resolution process.

Generally, if an investor does not wish to risk the counterparty accelerating the margin lending facility, or closing-out the trades under an ISDA, payment of the margin call should nonetheless be made **subject to express protest with a reservation of rights**. This will help preclude any arguments by the lender/counterparty that the investor has waived its right to challenge the margin call in question, or is estopped from doing so.

For disputes that have arisen 'after the fact', if the margin call was made in breach of contract (due to the invalidity of the call and/or an impermissible valuation) and the counterparty goes on to accelerate

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[19] *Sebastian Holdings* at [1199] per Cooke J.
[20] *Sebastian Holdings* at [1199] per Cooke J.
[21] *Sebastian Holdings* at [1201] per Cooke J.
[22] Paragraph 4 the CSA and CSA (VM).

or terminate the facility, then an investor may be able to **bring a counterclaim for wrongful termination**.

The invalidity of the call, or valuation made in breach of contract by the counterparty, will infect the subsequent acceleration or termination, such that the counterparty may be liable for any losses suffered by the investor as a result of that wrongful termination. This includes expectation damages and any losses suffered by the investor in the wrongful sale of the collateral; the latter of which is particularly important when the collateral is illiquid or has special rights attaching to equity positions.

(4) Liquidation and/or sale of the posted collateral

In both the ISDA and non-ISDA contexts, if a counterparty or lender holds collateral and becomes validly entitled to accelerate or terminate the facility when a margin call is missed, it will have the right to enforce on the collateral in order to pay off the balance of the outstanding debts or settle the outstanding trades. This is done by selling the collateral and accounting for the proceeds.

As noted above, if the investor can establish a valid claim of wrongful termination, then this wrongful act will infect the counterparty's subsequent liquidation of the collateral and will typically entitle the investor to claim damages for the losses it has suffered.

Accordingly, close attention should be paid to the following aspects of the sale of the collateral:-

- In the non-ISDA context, whether any express post-termination obligations on the counterparty or lender have been complied with to obtain the "*best possible price*" (or similar) for the collateral using "*commercially reasonable procedures*". These may exist in the facility agreement itself or in associated security documentation, and will usually require the input of a market practice expert.

- Whether any sale of collateral has been conducted on an arm's length basis.

- The documentation of the sale of any collateral and any resistance by the counterparty to provide details of the disposal, particularly where the collateral is illiquid.

In practice, where disputes turn on issues involving expert evidence, the ultimate prospects of the claim will depend very significantly on the credibility of the evidence that the expert is able to give on the relevant issues at trial. Accordingly, selecting the right expert is of critical importance.[23] Investors should ensure that they consider these matters carefully with their legal advisers.[24]

V. Challenges to margin calls in the post-Braganza era

There is a relative dearth of English case law on challenges to margin calls and the related enforcement of collateral under complex financial instruments, even after the turbulence of the 2008 financial crisis. This stands in marked contrast to the position in the United States, where there is an established body of case law on the topic: see our related Client Alert "US Outlook: Top Questions About Margin Calls". This is in part due to the effect of New York's Uniform Commercial Code ("UCC"), which

[23] Yasseen Gailani and John Finnerty, "Expert evidence to support or challenge Loss calculations: how credible is it?" (2015) 9 *Journal of International Banking & Finance Law* 583B.

[24] We have extensive experience of making these selections, as well as very good knowledge of the most suitable experts to assist in such disputes, and would be pleased to discuss these matters with any recipient of this Client Alert as appropriate.

provides that any liquidation of collateral following an unsatisfied margin call must be done in a manner that is "commercially reasonable".

Although English law lacks an equivalent to the UCC, the extreme volatility of the markets in 2020 and the resulting claims by investors, funds and other counterparties may result in closer attention being paid by the English courts to the exercise of contractual discretions inherent in making margins calls. As noted above, we are already seeing the first of these claims being filed against institutional investment bank counterparties. In this connection, this potential new wave of claims comes after a decade of significant developments in relation to contractual discretions under English law. We briefly explore these developments below:-

- The key development has been the UK Supreme Court's decision in *Braganza v BP Shipping Ltd* ("***Braganza***"), a case related to the exercise of a discretion under an employment contract, to give effect to an implied duty of rationality.[25] This had the effect of implying a term into the relevant contract so that the discretion in question had to be exercised in good faith, and not unreasonably, capriciously or arbitrarily.

- The potential effect of the so-called *Braganza* discretion applying in purely commercial contracts was soon afterwards considered by the Commercial Court. Mr. Justice Blair [26] found there was little, if any, scope to imply such a term in such contracts. Most relevantly, Mr. Justice Blair stated:

  > "*The contractual discretion in the present case is given to a commercial party to a contract with another commercial party on the wholesale financial markets where the decision is as to the valuation of securities in the case of default. The decision is one which can be (and may need to be) taken without delay, and in which the non- Defaulting Party is entitled to have regard to its own commercial interests. In this kind of situation, I do not agree with LBIE that Braganza requires the kind of analysis of the decision-making process that would be appropriate in the public law context."*[27]

- This analysis was recently re-iterated by the Commercial Court in the context of contractual rights that are expressed as absolute or unqualified.[28] Notwithstanding these developments, the same case stated more generally that "*the circumstances in which such terms can be implied into commercial agreements is an incrementally developing area of the law*".[29] Depending on how the express terms of margin lending facilities are drawn (and, to a lesser extent, the bespoke amendments to any ISDA facilities), there may be scope for these controls on contractual discretions to take a greater role. However, if the counterparty's rights are expressed in absolute or unqualified terms, there will be little (if any) room to imply *Braganza*-type qualifications.[30]

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[25] [2015] 1 WLR 1661 at [18].
[26] *Lehman Brothers International (Europe) v. Exxonmobil Financial Services BV* [2016] EWHC 2699 (Comm).
[27] *Lehman Brothers International (Europe) v. Exxonmobil Financial Services BV* [2016] EWHC 2699 (Comm) at [286].
[28] *TAQA Bratani Limited v Rockrose UKC58 LLC* [2020] EWHC 58 (Comm) at [53] per Blair J.
[29] *TAQA Bratani Limited v Rockrose UKC58 LLC* [2020] EWHC 58 (Comm) at [46] per Blair J.
[30] *TAQA Bratani Limited v Rockrose UKC58 LLC* [2020] EWHC 58 (Comm) at [46] per Blair J.

The events on the markets in 2020 have once again shown the potential for margin calls to give rise to disputes and subsequent litigation. Investors seeking to recover losses suffered as a result of margin calls may have a number of remedies open to them, as set out in this Client Alert.

If you have any questions about the issues addressed in this Client Alert, or would like to explore the validity of and/or scope for claims in relation to a margin call which your organisation has recently had to meet, please do not hesitate to reach out to us.

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