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Legal Update
May 2018

Determining "fair market value" in a distressed market: the Court of Appeal of England & Wales rules on interpretation of GMRA 2000

Following its entry into receivership during the height of the financial crisis in October 2008, the Icelandic bank Landsbanki Islands hf. (now "**LBI**") became liable to Raiffeisen Bank ("**RBI**") in respect of a series of "repo" transactions under which a portfolio of bonds had been provided as collateral for a loan. As the Defaulting Party, LBI had to pay RBI (the Non-Defaulting Party) a sum representing the agreed Repurchase Price for the securities minus the Default Market Value of Equivalent Securities, pursuant to the terms of the Global Master Repurchase Agreement (2000 version). The issue for the English Court of Appeal in *LBI EHF v Raiffeisen Bank International AG* [2018] EWCA Civ 719 was whether the Non-Defaulting Party's assessment of the "*fair market value*" of the securities could be based on prices achieved or quotations obtained in a distressed or illiquid market, or whether a "normal" trading environment should be assumed for the purposes of valuation.

Repo trades and the contractual framework

The Global Master Repurchase Agreement ("**GMRA**") is a model master agreement published by the International Capital Market Association, the trade body for the bond and repo (repurchase transaction) markets, and is the principal master agreement for cross-border repos globally.

LBI went into insolvent receivership on 7 October 2008. This constituted an Event of Default under the GMRA, pursuant to which LBI, as the Defaulting Party, would need to pay RBI, the Non-Defaulting Party, an agreed Repurchase Price for the securities lent, less the Default Market Value of Equivalent Securities. Under the GMRA, the Default Market Value fell to be determined by one of three valuation methods:

(1) the sale price achieved as a result of a sale of the bonds in good faith;

(2) the mean average of commercially reasonable quotations obtained from market makers for the bonds;

(3) where the Non-Defaulting Party has tried but been unable to sell the bonds or cannot obtain commercially reasonable quotations (i.e. failing (1) or (2) above), the Non-Defaulting Party can itself determine the Net Value of Equivalent Securities and elect to treat that Net Value as the Default Market Value.

Net Value is defined in the GMRA as follows:

> "*Net Value means at any time, in relation to any Deliverable Securities or Receivable Securities, **the amount which, in the reasonable opinion of the Non-Defaulting Party, represents their fair market value**, having regard to such pricing sources and methods (which may include, without limitation, available prices for Securities with similar maturities, terms and credit characteristics as the relevant Equivalent Securities or Equivalent Margin Securities) as the Non-Defaulting Party considers appropriate, less, in the case of Receivable Securities, or plus, in the case of Deliverable Securities, all Transaction Costs which would be incurred in connection with the purchase or sale of such Securities*" (emphasis added).

Only method (3) above was available in the circumstances of these trades because no Default Valuation Notice was validly served by LBI. The principal issue for the Judge at first instance was the appropriate Default Market Value in the circumstances; in particular, the meaning of "*fair market value*".

High Court decision

LBI had argued at first instance that the meaning of "*fair market value*" should be limited to involving a willing buyer, willing seller, knowledge of the asset in question, and a lack of compulsion. In other words, "*fair market value*" should not encompass or take account of conditions in a distressed market, such as those in October 2008 following the collapse of Lehman Brothers. The judge had rejected this narrow contractual interpretation, on the basis that such a reading was difficult to reconcile with other provisions of the GMRA; for example, valuation method (1) permits the Non-Defaulting Party to determine the Default Market Value by selling the securities in what may be a distressed market. Accordingly, the limits to "*fair market value*" argued by LBI were rejected, subject to the general proviso that the sale takes place in good faith and, applying the decision of Rix LJ in the *Socimer Bank* case, that the Non-Defaulting Party acts rationally and not arbitrarily or perversely.[1]

Court of Appeal decision

The Court of Appeal observed that the discretion conferred upon the Non-Defaulting Party by valuation method (3) is a broad one, as reflected in the definition of Net Value, which permits the Non-Defaulting Party to assess fair market value by reference to "*such pricing sources and methods … as the Non-Defaulting Party considers appropriate …*". The unduly narrow interpretation put forward by LBI was contrary to the nature of this broad discretion. In determining "*fair market value*" for the purposes of valuation method (3), the Non-Defaulting Party could have regard to any evidence and information as to the particular market conditions at that particular time, and its discretion was not fettered in the way contended by LBI.

The Court of Appeal therefore affirmed that the only limitation to the wide discretion afforded to the Non-Defaulting Party was that it must act rationally and not arbitrarily or perversely. It is only in this sense (the requirement to act rationally, and not arbitrarily or perversely) that the word "*fair*" adds anything to the meaning of the phrase "*fair market value*".

The main "*fallacy*" identified by the Court of Appeal with LBI's argument was that it appeared to suggest that where the Non-Defaulting Party is unable to sell or purchase securities or obtain commercially reasonable offers, this would somehow preclude it from taking into account the *actual* market value in its assessment of what constitutes the fair market value. The Court of Appeal found that, given that the very reason why a Non-Defaulting Party may be unable to buy, sell, or obtain commercially reasonable offers (i.e. unable to avail itself of valuation methods (1) or (2)) is likely to be an illiquid or distressed market conditions at the time, LBI's interpretation did not make much commercial sense either, and would result in an artificial inflation of the true market value of the relevant securities.

A number of Commonwealth cases had been cited to the Court of Appeal by LBI in support of its arguments. The Court did not consider these cases to be of assistance to LBI given that each contract must fall to be interpreted against its own context, and the circumstances in the cases cited were materially different. The Court also noted that it may be for this reason that a tailor-made definition of "*fair market value*" is not offered in the GMRA, given the wide variety of financial instruments and commercial contexts in which repo trades are conducted.

1 *Socimer International Bank Ltd v Standard Bank Ltd* [2008] EWCA Civ 116

Conclusion

Although each contract will be interpreted against its own factual matrix, this decision clarifies the meaning of "*fair market value*" in the context of the GMRA and how it may (not) be determined. In short, "*fair market value*" is the same as market value and may take account of distressed market conditions, as long as it is calculated rationally and not arbitrarily or perversely.

If you have any questions or comments in relation to the above, please contact Susan Rosser or Stephen Moi, or your usual Mayer Brown contact.

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