COVID-19: CRISIS MANAGEMENT FOR END-USERS OF SWAPS AND REPOS: KEY ISSUES IN RESPONDING TO MARGIN CALLS AND EARLY TERMINATION NOTICES

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

Counterparties to swap and repurchase transactions have come under pressure following the financial dislocations caused by the novel coronavirus pandemic in 2020 (“COVID-19”). Falling and illiquid markets may result in margin calls that create immediate liquidity risk and may lead to an event of default if required margin is not posted in accordance with the 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 to maintain required net asset value (“NAV”) levels and potentially bankruptcy if NAV declines impair a fund's solvency. For many end-users, these financial strains can be life-threatening.

Market turmoil also creates risks for enforcing counterparties. If they call on margin or terminate transactions and liquidate posted swap 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.

OVERVIEW OF SWAPS AND REPOS

Swaps

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.

Swaps are generally documented under two forms of standard master agreements 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”). Specifically negotiated contractual terms are contained in a schedule that supplements and often modifies the provisions of an 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 an English or New York law credit support annex in the form published by ISDA (the “CSA”). CSAs typically provide for margin calls by the secured party if collateral market values fall below a credit-adjusted amount that approximates the secured party's current mark-to-market exposure to all affected transactions under an ISDA master agreement.

Repos

Repurchase transactions are a type of short-term secured lending, often used to provide leverage for securities and mortgage-related assets. They are documented by standard master agreements published by the Securities Industry and Financial Markets Association and governed by either English law (the “GMRA”) or New York law (the “MRA”). The GMRA is used exclusively for securities, while the MRA is also used for other assets, most notably mortgage loans.

Both the GMRA and MRA provide for margin calls by the repo buyer if the market value of the repo'd assets falls below an agreed threshold percentage above their original purchase price (the “Margin Ratio” in the GMRA, or the “Buyer's Margin Percentage” in the MRA). This margin ratio must be maintained at all times until the repurchase date and is calculated on an aggregate basis for all repo transactions under a GMRA or MRA.

MARGIN CALLS IN VOLATILE MARKETS: HOW IS COLLATERAL VALUED?

Valuation is the key issue with margin calls. Once the secured party has determined that swap collateral or repo'd assets have decreased in value below the contractually agreed margin level, it may opt to issue a demand for additional collateral. Failing to meet a margin call can lead to termination of the related swap or repo master agreement and all covered transactions, followed by liquidation of all pledged collateral or repo'd assets.

But who determines whether the value of collateral or repo'd assets is insufficient to cover the exposure on the swap or repo transactions, particularly if the market for such assets is volatile or, worse, nonexistent? And who determines the price for such assets if there are no reliable bids in a potentially frozen market?

Swaps

Under industry practice, the party responsible for valuing collateral under a CSA is typically “Party A,” the bank offering the swap product.

But margin calls for swaps can be disputed. Each CSA contains a dispute resolution mechanism, whereby the party pledging collateral may demand a recalculation by the secured party, which may then either resolve the dispute or try to get market quotes to support a recalculation — in effect buying time for an additional few business days after the margin call. Undisputed amounts must be transferred to the secured party, but disputed amounts present the secured party with a choice: go through the recalculation procedure and then enforce the failed margin call as an event of default (entitling it to terminating all swap transactions under the ISDA master agreement) or agree on a negotiated resolution.

Repos

Margin calls under repurchase transactions are contingent on a determination of the current mark-to-market value of the repo'd assets, i.e., their “Market Value.” The definition of “Market Value” for purposes of margin calls is generally similar under the MRA and GMRA — but is often carefully negotiated in amendments in annexes. So the annex provisions should always be consulted when assessing the reasonableness of margin calls.

The MRA and GMRA define “Market Value” as the price obtained from a generally recognized source agreed to by the parties, but some negotiated annexes vest discretion in selecting a pricing source in the repo buyer (i.e., the lender) if the parties cannot agree. Unlike ISDA swap agreements, the MRA and the GMRA do not contain dispute resolution provisions 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 secured party then faces a similar choice as with a swap: enforce the failed margin call as an event of default (entitling it to terminate all repo transactions under the MRA or GMRA) or negotiate a resolution.

EVENTS OF DEFAULT OR TERMINATION EVENTS: KEY ISSUES IN VOLATILE MARKETS

In addition to the risks of failed margin calls, 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.

When Do NAV Triggers Occur?

NAV maintenance covenants may be particularly important, as the failure to satisfy required asset levels may result in a termination event under a swap or a breach of covenant under an MRA or GMRA. NAV covenants are typically set forth in negotiated ISDA schedules or MRA or GMRA annexes, and they 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).

As with margin calls, the key issue with NAV triggers is how they are measured and by whom and when. The specific procedures for NAV measurement in the negotiated swap or repo text must be consulted to determine when a covenant might be tripped. For example, when was the most recent NAV measurement provided to the secured party, and when will the next NAV measurement be provided? These parameters may guide the possible room for maneuver, including the time period between NAV measurements during which new capital infusions might be needed to boost fund asset values before an NAV trigger risks being tripped.

When Does “Insolvency” Occur?

There may also be some room for maneuver in determining when and whether an “insolvency” event has happened or might happen. Insolvency is an event of default for both 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 legal proceedings (voluntary or involuntary), but they 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 (the 2002 ISDA master agreement 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 made). They do not define the term “insolvent,” so there may be some leeway for determining insolvency.

Insolvency is typically determined on a balance sheet basis (assets less liabilities), but it may also be determined on a cash flow basis (inability to pay debts as they become due) or undercapitalization basis (insufficient assets for contemplated business plans). This may pose significant practical challenges for a fund facing margin calls or acceleration threats 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.

But the flip side is also true: An enforcing party 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.

Do COVID-19 Events Constitute Force Majeure or "Illegality" for Swaps?

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.[1]

This issue is relevant to swaps as it raises the question of whether a termination event may exist for "Illegality" (i.e., a covered transaction becoming illegal) or (in the 2002 ISDA master agreement) "Force Majeure." Under the 2002 ISDA master agreement, a "Force Majeure Event" termination event arises if by reason of force majeure or act of state occurring after a transaction is entered into, swap payments or margin calls are made impossible as a practical matter, such as through office closures or shutdown of payment methods. Such events entitle an affected party a temporary standstill period, preventing swap termination for three business days for an "Illegality" or eight business days for a "Force Majeure Event."

However, it is unlikely that the COVID-19 crisis will trigger an "Illegality" or a "Force Majeure Event" for swaps so long as the relevant markets, payment channels, and clearing systems remain open and custodians, dealers, or other intermediaries remain operational. The 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.

CLOSE-OUT AND LIQUIDATION BY A SECURED PARTY: WHEN IS IT "COMMERCIALLY REASONABLE"?

A primary issue for early termination of a swap or repurchase agreement is whether the terminating party acted in a "commercially reasonably" manner: in both determining the net amounts due on termination and in liquidating any collateral or repo'd assets held by the terminating party.

As with margin calls, a key issue is valuation, i.e., how valuations were determined or obtained. What is "commercially reasonably" behavior in an illiquid market, when values are difficult or impossible to determine?

Swaps

Under the 2002 ISDA master agreement, the terminating party must determine its "Close-out Amount": the cost of replacing the swap transaction (i.e., obtaining its economic equivalent), which it must determine in good faith and using commercially reasonable procedures, to produce a commercially reasonable result.

Under the 1992 ISDA master agreement, the terminating party must calculate the early termination amount based on the contractually agreed measure: either "Market Quotation" (i.e., market value based on quotes from leading dealers) or "Loss" (i.e., net losses reasonably determined in good faith). If the parties did not select a payment measure, "Market Quotation" applies, unless a market value cannot be determined or (in the reasonable belief of the terminating party) would not produce a commercially reasonable result, in which case "Loss" applies.

Repos

Under the New York law MRA, on a default by the repo seller, the repo buyer may either sell the repo'd assets and apply the proceeds to the repurchase price, plus any other MRA amounts due and collection costs, or instead elect to credit the value of the repo'd assets based on market price quotes against the total amount due, then make a claim for any deficiency.

Under the English law GMRA, the close-out process has three stages: (1) acceleration of all repo 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. The terminating party has three methods for determining “Default Market Value”: (1) sell the repo'd assets, at whatever price is obtainable in the market, and use the actual price received; (2) obtain bid or offer quotations from at least two market makers; or (3) if those two methods fail, use the terminating party's own methodology in good faith to ascertain a reasonable price under the prevailing circumstances.

Case Law Standards for Netting and Collateral Disposition

English courts give disposers of collateral considerable leeway in the manner in which they determine the disposal value of collateral. While 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. Any deficiencies in the calculated close-out amount after collateral disposition may be asserted as an unsecured claim in an insolvency proceeding of the defaulting party.

For swaps and repos governed by New York law, liquidation of collateral must generally comply with a standard of “commercial reasonableness” — including as to method, manner, time, place, and other terms.[2] Under the Uniform Commercial Code (the “UCC”) in New York, a commercially reasonable collateral disposition includes where the 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 other methods.[3]

Litigation in the United States has arisen where “recognized markets” are illiquid or disrupted, mainly in connection with the 2008–09 financial crisis. These cases may have particular relevance to collateral dispositions during the market volatility caused by the COVID-19 pandemic. Case law from that time under the U.S. Bankruptcy Code and the UCC articulated several criteria to be considered in the disposition of hard-to-value financial assets. These include the appropriateness of mark-to-model valuations (i.e., based on internal models of the secured party or repo buyer) where there is no market for the financial assets in question, and the extent of market disruption that is necessary before it is commercially unreasonable to dispose of collateral through common market-clearing techniques such as conducting a bids-wanted-in-competition auction.

U.S. Bankruptcy Considerations

In the event a defaulting party has filed for bankruptcy in the United States, various statutory safe harbors permit the nondefaulting party to proceed to termination and liquidation notwithstanding the bankruptcy filing and resulting automatic stay. These are set forth in several provisions of the U.S. Bankruptcy Code for swaps, repos, other types of financial contracts, and related netting agreements.[4] 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 party's bankruptcy proceeding.

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, admonishing that nondefaulting parties may not unduly “game” a bankruptcy filing by deferring their termination notices until market movements make their positions “in the money.” Others have limited safe harbor setoff to pre-bankruptcy debts only (i.e., imposing a U.S. bankruptcy requirement of "mutuality") or limited setoff and netting to debts that are expressly related to the underlying swap or repo contracts. These issues are relevant to the default and foreclosure process — i.e., to the parameters of which remedies a nondefaulting party might choose and when — and to broader insolvency planning by a defaulting party as well, including assessing the likely impact of a bankruptcy filing on its portfolio of swaps, repos, and other financial contracts.

CONCLUSION

COVID-19 has destabilized financial markets and financial assets in ways not seen since the fall of Lehman Brothers 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 margin calls. In such potentially dire circumstances, some areas of ambiguity in the industry-standard forms of contract may offer room for maneuver. Even if the party making margin calls has the power to impose its marks and exercise termination rights, the question whether such actions were commercially reasonable is an important one that may be litigated long after the liquidation of the collateral following early termination of the transactions in question.

FOOTNOTES

[1] For a general discussion of force majeure clauses in the United States in the context of COVID-19, see our client alert here.

[2] *See generally* N.Y. U.C.C. § 9-610.

[3] *Id*. § 9-627(b)–(c).

[4] *See* 11 U.S.C. §§ 555–556, 559–562; *id*. § 362(b)(6), (7), (17), (27), (o). Parallel safe harbors apply if the defaulting party is a Federal Deposit Insurance Corporation-insured financial institution, a registered broker-dealer or a commodity futures commission merchant.

KEY CONTACTS

BRIAN D. KOOSED
PARTNER

WASHINGTON DC, NEW YORK
+1.202.778.9204
BRIAN.KOOSED@KLGATES.COM

ANTHONY R.G. NOLAN
PARTNER

NEW YORK
+1.212.536.4843
ANTHONY.NOLAN@KLGATES.COM

ROBERT T. HONEYWELL
PARTNER

NEW YORK
+1.212.536.4863
ROBERT.HONEYWELL@KLGATES.COM

