ALLEN & OVERY

MEMORANDUM TO ISDA MEMBERS

(24 MAY, 2000)

Peregrine Fixed Income Limited (in liquidation) ("Peregrine")
-v-
Robinson Department Store Public Company Limited ("Robinson")

Introduction

Mr Justice Moore-Bick at the High Court in London gave judgment in the above case on 18th May, 2000 in favour of Peregrine. The Judge's decisions on the issues before him, and his reasoning for those decisions, raise potentially serious issues in relation to the valuation and close out mechanics of the 1992 ISDA Master Agreement (the "Agreement"). This case was presented to the Court by Peregrine as being "in the nature of a test case" regarding "fundamental provisions" of the Agreement. Peregrine has now presented the judgment as "the test case in respect of the ISDA valuation issue", although it seems unlikely that other potentially affected counterparties and ISDA users would have accepted that the highly unusual facts of this particular case were an appropriate basis for a decision on the interpretation of the Agreement generally. Whatever label is put on it, this case only determines the position (subject to any possible appeal) between the two actual parties to the case, Peregrine and Robinson. It should be noted that ISDA itself was not a party to the case, was never invited to express its views or to make representations to the Court on these issues and did not do so.

Key points from the case

- "Loss" provides a benchmark against which Market Quotation should be assessed, and the commercial reasonableness of Market Quotation in any case will be determined by reference to that Loss benchmark. The court reached this conclusion despite the fact that there is nothing in the Agreement to suggest this analysis and even though the Court provides no guidance on how far Market Quotation must stray from Loss before it is to be considered commercially unreasonable.

- Creditworthiness of the Non-defaulting Party is a permissible factor in calculating Market Quotation, but not in calculating Loss. A Non-defaulting Party will, it seems, have to calculate its Loss (including "gain") by reference to "standard swap rates" even if it could not itself access those rates and even though any Market Quotation it obtains may reflect that creditworthiness.

- Agreeing in advance that a way of calculating loss and damage is to be regarded as a "genuine pre-estimate" may not prevent the Court (by applying the "commercially reasonable" result test in the definition of "Settlement Amount") over-ruling the parties' agreement if the actual loss is very different.

Background

Peregrine and Robinson, a Thai company, had entered into an Agreement governed by English law, in which Market Quotation was elected as the payment measure, Second Method was elected as the payment method and automatic early termination was specified to be applicable to both parties. With one transaction outstanding, Peregrine defaulted under Section 5(a)(vii)(6) and an Early Termination Date was automatically deemed to occur on 15th January, 1998. Subsequent to the designation of the Early Termination Date, Robinson itself entered into a court-sanctioned restructuring in Thailand.

The full details of the transaction (most notably the Confirmation setting out the trade details) were not revealed to the Court, but the following points emerged: at the time of the deemed occurrence of the Early Termination Date, Peregrine did not have any remaining payment obligations. Robinson was conditionally obliged (i.e. subject to Section 2(a)(iii) of the Agreement) to make 25 annual payments to Peregrine of a fixed amount of US$6.85m.

Upon the deemed occurrence of the Early Termination Date, it was for Robinson (as the Non-defaulting Party) to determine a Market Quotation. Robinson obtained quotations from Reference Market-makers in December 1999. (The point that Market Quotations should be obtained "on or as soon as reasonably practicable after the Termination Date" was apparently not taken.) As Robinson was out of the money at the Early Termination Date, the quotations obtained from the Reference Market-makers were for the amount that each of them would have paid to Robinson at the Early Termination Date in consideration of entering into a Replacement Transaction with Robinson (i.e. in consideration of the expectation of receiving the stream of 25 annual payments from Robinson). The parties agreed (at some unspecified stage) that the "discounted present value" of such a future payment stream (discounted only for time value using what were described as "generally accepted US dollar swap rates" and without reference to Robinson's credit standing) was US$87.3m. The three Market Quotations obtained by Robinson were (roughly) US$750,000, US$9.5m and US$25.5m. Taking the middle quotation, as required by the Agreement, Robinson therefore determined a Market Quotation of US$9.5m. As Second Method was specified to be applicable, this was an amount that was due from Robinson to Peregrine, even though Peregrine was the Defaulting Party.

It was Peregrine's case (based on paragraph (b) of the definition of "Settlement Amount") that, even if Market Quotation is specified by the parties, the Loss measure must be applied in circumstances where the Non-defaulting Party cannot have formed a reasonable belief that using the Market Quotation measure would produce a commercially reasonable result. Specifically, Peregrine contended that, because the Market Quotation figure of US$9.5m was so much lower than the discounted present value of US$87.3m, it was unreasonable for Robinson to apply the Market Quotation measure. Instead, Peregrine contended that Robinson should have applied the Loss measure and the correct Loss measure is simply the discounted present value of the future payments, namely US$87.3m.

The case principally involved consideration by the Judge of the interpretation and inter-relationship of: (a) the various sub-sections in Section 6(e) relating to Payments on Early Termination; (b) the underlying purpose of the payment measures in Section 6(e); (c) the definition of "Market Quotation"; (d) the definition of "Loss"; and (e) the definition of "Settlement Amount".

The Judge's decisions

The Judge was asked to determine five questions. Those questions, and the Judge's answers (with short further explanation under "Note"), were as follows:

(1) Q: Is Peregrine entitled to challenge Robinson's belief that the Market Quotation payment measure has produced a commercially reasonable result?

A: YES.

Note: The Judge concluded that the mere fact that a Non-defaulting Party succeeds in obtaining a Market Quotation does not preclude the use of the Loss measure if, for reasons that the Non-defaulting Party failed to appreciate when it sought the Market Quotation, the use of that Market Quotation to determine the Settlement Amount would produce "an obviously unreasonable result".

(2) Q: If so, does the Market Quotation payment measure produce a commercially reasonable result?

A: NO.

Note: The Judge considered that, by reference to the "aims and objects of the Agreement" as a whole, where the Market Quotation produced a result as far removed from the result that would have been reached applying the Loss measure as it did in this case, then the result was commercially unreasonable. Robinson could not have reasonably believed otherwise if it had taken proper account of the relevant factors, most notably the "substantial difference" between the amounts payable applying the Market Quotation measure and the Loss measure.

(3) Q: If the answer to question (2) is "No", is Peregrine entitled to require Robinson and/or is Robinson bound to use the Loss payment measure in determining the Settlement Amount?

A: YES.

Note: Given the judge's conclusion on questions (2) and (3), this must follow.

(4) Q: If the answer to question (3) is "Yes", ... is Loss to be determined (a) as Peregrine contends; or (b) as Robinson contends?

A: (a) AS PEREGRINE CONTENDS.

Note: Peregrine contended that Robinson's "gain" was the present discounted value of the payment stream due from Robinson to Peregrine, being $87.3m. However, the cost of funding that payment was not part of the calculation. It follows that the Judge did not accept that a Non-defaulting Party that obtains a "gain" from being relieved of an obligation at the same time suffers a loss or cost from having to make the requisite Settlement Amount payment. If this had been taken into account, it would have resulted in a significantly reduced "net gain" (and broadly similar to the Market Quotation figure) given Robinson's costs of funds.

(5) Q: Without prejudice to the generality of question (4), is the creditworthiness of Robinson relevant to the assessment of Loss and if so, is there any condition, limitation or

restriction on the extent to which, or in respect of the manner in which, such creditworthiness should be considered as relevant or taken into account?

A: NO.

Note: The Judge of course meant that Robinson's creditworthiness is not relevant to the assessment of Loss, i.e. he was answering the first part of this question.

The Judge's reasons

In brief the judge's reasoning was as follows:

- Market Quotation and Loss are supposed to reach "broadly the same result".
- Market Quotation entitles Reference Market-markers to take a Non-defaulting Party's creditworthiness into account.
- Where a Non-defaulting Party is due to make, but not receive future payments, "Loss" is primarily determined by the gain to that party represented by being relieved of its obligation to make future payments.
- This gain is, effectively, the present discounted (or nominal) value of the future payments and there is no reason to adjust that by reference to the Non-defaulting Party's ability to perform nor, if different, is the cost of making payment to the Defaulting Party of that gain to be taken into account.
- If the Market Quotation figure is substantially different from the Loss figure, then applying the Market Quotation measure must lead to a commercially unreasonable result.
- A Non-defaulting Party who seeks to apply the Market Quotation measure in these circumstances cannot therefore have formed a reasonable belief that Market Quotation would lead to a commercially reasonable result.

Looking at the judgment in more detail:

What most troubled the judge was how an obligation with a nominal present value of US$87.3m could only be worth US$9.7m and why a Market Quotation valuation, which ought to be reliable, should be so different from the value attributed to the contract for loss of bargain.

It was common ground that Reference Market-makers are entitled to take into account the financial standing of the Non-defaulting Party in giving quotations for a Replacement Transaction with that party. That said, the Judge determined that the intention behind the Agreement is that the Market Quotation measure and the Loss measure are intended to lead to broadly the same result. In support of this, the Judge referred to (a) the Court of Appeal's decision in *ANZ -v- Société Générale* [2000] 1 All ER (Comm) 682 where it also considered that this was the intention; (b) his view that Section 6(e)(i)(3) and Section 6(e)(iv) both indicate that "the Market Quotation measure and the Loss measure are intended to lead to broadly the same result"; and (c) his view that the definition of Settlement Amount recognises that there may be circumstances in which the Market Quotation measure may <u>not</u> operate satisfactorily and that this supports the proposition that Loss "provides a benchmark by reference to which the Market Quotation measure should be judged".

The Judge noted Robinson's view that, in the case of an Event of Default, the Second Method was concerned only with preventing the Non-defaulting Party from obtaining a windfall benefit as a result of the default and that it was not intended to enable the Defaulting Party to obtain "the full benefit of any obligations owed to him". The Judge did not accept Robinson's view because: (a) the object of the Second Method was to move away from a breach-based approach; (b) the position of a single Affected Party under Section 6(e)(ii) exactly mirrors the position under Section 6(e)(i)(3) and (4); (c) Section 6(e)(iv), in providing that a Market Quotation is a reasonable pre-estimate of loss and is an amount payable for the loss of bargain, supports the view that the whole of Section 6(e) is intended to reflect loss of bargain (a category of damage fundamental in the normal course to measuring loss for breach of contract).

The Judge did not accept that Robinson's cost of funding an immediate payment of US$87.3m was relevant to the calculation of its "gain" under the Loss definition. He concluded that the definition of Loss was intended to go some way towards identifying the heads (or categories) of Loss which can be taken into account when analysing the position under a transaction, but has nothing to do with the means by which any amount ultimately payable is to be funded.

The practical result in this case was that Market Quotation and Loss (measured by reference to the scheduled payments and without reference to credit) reached very different results. As the Judge's view was that this was not supposed to happen the Judge concluded that one of the measures must be wrong (or "commercially unreasonable") in this case. As the Agreement expressly contemplates the possibility of Market Quotation being unreasonable in unspecified circumstances (as determined by the Non-defaulting Party) and as the overall purpose was to achieve a figure based on loss of bargain, Loss must be the measure to follow in such circumstances.

Comments

The Judge acknowledged that the facts of this case were highly unusual. He commented that "in reality Peregrine was simply holding a long-term unsecured debt due from Robinson" and that "this case is far from being typical of those to which these provisions [i.e. the provisions of the Agreement] are likely to apply. Only one transaction between these two parties has been affected ... and that transaction is itself far from being a typical swap transaction". The very unusual facts (which were not fully revealed to the Court) may have influenced the Judge's interpretation and analysis of the Agreement. In particular, the transaction (at least on the facts available to the Court) looked very much like a long-term debt, even though it was in fact a transaction documented under the Agreement, thereby making any payment obligations of Robinson conditional on, among other things, Peregrine remaining solvent.

The key issue that troubled the Judge was how to reconcile the enormous difference between the figure reached by applying Market Quotation and the figure reached by applying Loss. It is worth noting that, in applying Loss, the Judge appeared to focus on the theoretical result that would have been achievable if there had been no Event of Default rather than the actual result that would have been achievable by the Non-defaulting Party entering into a replacement transaction following an Event of Default. Taking the difference arising from this approach however, there are three possible ways to address it:

1. It is only a problem at all if it is correct that the two measures <u>must</u> always lead to "broadly the same result". It is not clear why that should be the case:

- There is nothing in the language of Section 6(e)(i)(3) which of itself suggests that it is necessarily intended to reach the same result as Section 6(e)(i)(4).

- In this context, the Judge also relied on the reference to loss of bargain in Section 6(e)(iv). The fact that Section 6(e)(iv) only refers to Market Quotation is of course consistent with the possibility that Market Quotation may indeed lead to a different result from that obtained by applying the Loss measure. If the true measures must lead to "broadly the same result", there would be no obvious need for the stipulation that Market Quotation is agreed to be a reasonable pre-estimate. Fundamentally, the Market Quotation measure[1] is intended as an agreed "pre-estimate", whereas "Loss" self-evidently is not. It appears that this decision may be taking a different approach on the pre-estimate issue to that applied by the New York Courts under New York law[2].

- Nor does it follow that, because the definition of Settlement Amount allows for a fall back from Market Quotation to Loss in limited circumstances, the measures were intended always to reach the same result. It may simply be a recognition of the fact that Market Quotation may in some circumstances be distorted by extraneous factors which are not intended to be taken into account and, therefore, another method necessarily has to be applied.

- Finally, the Judge himself recognised that "the Market Quotation measure is, therefore, one which in certain circumstances may result in the payment which has to be made by the Non-defaulting Party to the Defaulting Party under Section 6(e) failing to a substantial degree to reflect fully the nominal value of the obligation owed by the Non-defaulting Party". This appears to be an acceptance by the judge that the language of the Agreement does envisage precisely the result that he rejected by finding Market Quotation to be commercially unreasonable in this case.

2. The second way to deal with a difference between Market Quotation and Loss is to decide that, in the given circumstances, the Market Quotation measure is wrong because it is not sufficiently close to the Loss measure. Thus, Market Quotation is to be verified by reference to a "Loss" benchmark. This is the route in fact taken by the Judge. This creates a practical problem because it essentially requires that damages be calculated twice in all circumstances, once using the Market Quotation and then, as a benchmark for comparison purposes, based on the Loss formulation. A further troubling aspect of this approach is that the Judge found that the Non-defaulting Party's creditworthiness is appropriately taken into account for Market Quotation, but not for Loss. On the facts of the case and on the Court's interpretation, Robinson's creditworthiness accounts for the huge difference between the results under Market Quotation and Loss. It is difficult to see, as a matter of principle, why the one measure (Market Quotation) should be considered unreasonable because it differs from the other measure (Loss) where the difference is wholly explicable by reference to a factor expressly agreed to be relevant to the first measure but not the second.

3. The third way to reconcile the difference is to decide that the figure achieved by the application of the Loss measure is, in the given circumstances, wrong because it is not sufficiently close to the Market Quotation measure. Put another way, if that is the superficial conclusion it may be possible to interpret Loss in such a way that the superficial difference in results does not arise. For example, if the Judge had been prepared to accept that it was legitimate, in calculating Loss,

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[1] As a matter of principle, there seems to be nothing inherently objectionable in a liquidated damages type clause setting out an agreed method of determining the sum payable, rather than a specified sum.

[2] See, for example, Drexel Burnham Lambert Products Corporation -v- Midland Bank plc (SDNY 1992).

to take into account the cost to Robinson incurred "in connection with this Agreement" by the requirement to make a payment to Peregrine under Section 6(e), the apparent difference would, very largely, have disappeared. This could equally have been achieved, without even looking at cost of funding the Settlement Amount, if the present discounted value of the future payment stream had been calculated by reference to rates relevant to Robinson rather than to a notional counterparty able, unlike Robinson, to access the standard spread of US dollar interest rates.

In summary, where there is an Event of Default, the payment measures should presumably be aimed at calculating the negative effect of that default on the position of the Non-defaulting Party. The negative effect on its position where it is out of the money is that, through no fault of its own, it is having to make immediate payment of a lump sum. Its "loss of bargain" is that the transaction has terminated early and that it must pay a lump sum on an accelerated basis. An element of its loss will be determined by its ability to fund the lump sum payment. Market Quotation takes into account its creditworthiness and reflects this acceleration aspect of loss of bargain on its part. Looking at loss of bargain under "Loss" solely in terms of the Non-defaulting Party's gain in being relieved of an obligation to make future payments is equivalent to looking at it in terms of the Defaulting Party's right to receive those future payments. In other words, it erroneously equates the Non-defaulting Party's gain with the Defaulting Party's loss.

Whilst it may well be correct, as the Judge found, that Second Method was intended to remove some of the consequences of treating default simply as any other breach of contract, it seems surprising that the Second Method, by requiring the Non-defaulting Party to pay any "gain" to the Defaulting Party, was ever intended to have the effect of putting a Non-defaulting Party into a worse position than if the transaction had not terminated. However, this is precisely the effect of not ensuring that full account is taken of all negative consequences for the Non-defaulting Party.

Conclusion

This case could lead to some unexpected consequences. For example:

1. It effectively means that whenever a Non-defaulting Party itself is out-of-the-money and has deteriorating credit, Market Quotation will lead to a commercially unreasonable result.

2. Parties with deteriorating credit may find themselves having to fund unexpected (and unexpectedly large) payments where a counterparty defaults.

3. Parties are not making a true election between measures in deciding between Market Quotation and Loss, as Market Quotation will have to be assessed by reference to the Loss "benchmark", rendering Market Quotation largely redundant.

4. There is, however, no objective way of knowing whether one result is to be treated as "broadly the same" as another.

5. Absent external requirements (notably, but ironically, for capital treatment), there will be a disincentive for parties to elect Second Method. Nobody, including presumably the regulators, expected that a Non-defaulting Party might have to pay out more than it could actually recover from a replacement transaction.

6. Subject of course to cross-default issues, there may even be an incentive for a party to default deliberately in circumstances where its counterparty's credit is deteriorating, particularly where the party that defaults is in the money vis-à-vis the deteriorating credit. A claim that is not affected by the deteriorating credit quality is thereby crystallised.

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