



UK COURTS REMAIN HANDS-OFF

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Spell out in your contract who has control over valuations in the event of insolvency. Or the court will do it for you.

We are likely to see increasing numbers of UK capital markets contracts being unwound as events of default occur. In such circumstances the non-defaulting counterparty often determines the default valuations of the remaining assets. But if so, how far can it perform the valuation in its own interests - and how far is it obliged to ensure fairness to the party in default? This is likely to be an area of increasing controversy while defaults increase and thin markets made pricing difficult.

The recent UK Court of Appeal decision in *Socimer International Bank Ltd v Standard Bank London Ltd* gives helpful guidance. The claimant bank, Socimer, agreed to a forward purchase from the defendant, Standard Bank, of various emerging markets securities. It defaulted on its obligations to pay for the securities, and on the relevant termination date owed Standard Bank \$24.5 million.

The contracts were governed by Standard Bank's standard terms for forward sale transactions, which allowed the seller to liquidate or to retain the portfolio of securities (Designated Assets) remaining in its hands at the time of the buyer's default. The relevant clause provided: "The value of any Designated Assets liquidated or retained and any losses, expenses or costs arising out of the termination or the sale of the Designated Assets shall be determined on the date of termination by Seller."

In other words the agreement provided the seller, Standard Bank, with a unilateral power to value the relevant assets on an event of default, which was not subject to any express restrictions or valuation processes. In this respect the default valuation differed from the terms used in the International Securities Market Association and Public Securities Association agreements, which limit the seller's discretion in certain defaults by reference to the concept of an agreed default market value.

Rather than valuing the assets on the termination date, Standard Bank sold them piecemeal, not crediting Socimer with the proceeds until sale. Through its liquidator, Socimer issued proceedings alleging that there was an implied term in the contract that the non-defaulting party was bound to take reasonable care to find the true market value. As an alternative, Socimer also argued that Standard Bank had similar obligations under the law of equity, by analogy with the duties of a mortgagee with a power of sale.

Socimer was successful at first instance, but that decision was overturned on appeal. In the leading judgment, Lord Justice Rix emphasised the courts' reluctance to go beyond the express words of a contract. He said that while the courts were prepared to impose implied terms in exceptional circumstances where this was necessary to ensure the business efficacy of a contract, this should be done as sparingly as possible - especially with sophisticated parties that had negotiated a carefully worked-out contract.

The Court of Appeal ruled that Standard Bank was under an implied duty to make its decision in good faith and in a rational manner, but that that was the limit of the implied obligations. It defined a rational decision as one demonstrating an absence of arbitrariness, capriciousness, perversity and irrationality. These, the court said, were the minimum standards imposed by the law when someone had unilateral power to make decision under a contract that could also affect the other contracting party. But Standard Bank was not obliged to reach reasonable or fair valuations.

The judgment included the following points, which may be important to future rulings in this area:

- A forward sale is not a type of mortgage transaction. Consequently the rules of equity, which protect mortgagors from unreasonable behaviour on the part of mortgagees do not apply.
- The seller of a volatile and illiquid asset may properly require a wide discretion in the default valuation provision to protect it from bearing too much risk following a default by a buyer. Accordingly, the contract worked without having to imply any additional terms. To imply a term requiring that the valuation be reasonable was an "unnecessary and unreasonable imposition".

As in its ruling last year in *IFE v Goldman Sachs*, the Court of Appeal has made clear its reluctance to interfere with the rights and obligations of experienced market participants as expressly set out in the transaction documentation. In practical terms, this case reinforces the need to spell out in as much detail as possible the extent

(and limits) of any discretion a non-defaulting party may have in assessing the value of retained securities at the time of a default. It is a clear warning that if the parties do not do this, the court will not do it for them.

This ruling shows, at a time when many parties to capital markets contracts are examining their rights and obligations, that English courts remain reluctant to re-write commercial contracts after the event, or impose their own idea of fairness. Nonetheless, the court's decision was dependent on the particular facts of the case, and leaves open many questions.

For example the Court of Appeal considered that Standard Bank was entitled primarily to consult its own interests, and that the requirements of good faith and rationality were enough protection to guard against abuse caused by that self-interest. But just where will the courts draw the line between a decision made in "good faith" and "rationally", and one that is not? And what happens when a more structured default valuation mechanism breaks down in the face of non-existent prices and extreme differences of opinion? These types of questions will be on the minds of many market participants, and also perhaps their auditors, over the coming months - and may well mean that the *Socimer* ruling is not the last word on this subject.

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