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DERIVATIVES

BDC Finance v. Barclays: Derivatives Collateral Calls in a Chaotic Market

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A series of decisions by all three levels of the New York State court system in *BDC Finance L.L.C. v. Barclays Bank PLC*, which culminated recently in a Court of Appeals decision remanding the case to the Supreme Court for trial, provides a window into the normally opaque world of collateral calls for over-the-counter derivatives transactions and offers some important lessons for hedge funds and other market participants.

The Total Return Swap

The events at issue in *BDC Finance* played out in the weeks following Lehman's September 2008 bankruptcy filing, when markets were particularly volatile. In 2005, BDC and Barclays had entered into a series of total return swap transactions, pursuant to which BDC was to make "financing" payments to Barclays, and receive returns based on specified "Reference Assets," consisting of leveraged loans owned by Barclays. The parties' agreement was documented using a 1992 ISDA Master Agreement and Schedule, an ISDA Credit Support Annex (CSA) and Paragraph 13, and a Master Confirmation.

The parties' CSA provides that both Barclays and BDC could make collateral calls. It also provides that the obligation to post collateral is subject to the condition precedent that there be no Event of Default or Potential Default (i.e., an Event of Default as to which the cure period has not expired). The Master Agreement, in turn, provides that an uncured failure to post collateral is an Event of Default.

The parties' CSA contains standard provisions regarding collateral-call dispute resolution, in relevant part as follows:

> **Paragraph 5. Dispute Resolution**
>
> If a party (a "Disputing Party") disputes (I) the . . . calculation of a . . . Return Amount . . ., then (1) **the Disputing Party will notify the other party** . . . not later than the close of business on the Local Business Day following (X) the date that the [collateral call] is made . . ., **the appropriate party will Transfer the undisputed amount** to the other party not later than the close of business on the Local Business Day following (X) the date that the [collateral call] is made . . ., (3) **the parties will consult with each other** in an attempt to resolve the dispute and (4) if they fail to resolve the dispute by the Resolution Time, then:
>
> (i) In the case of a dispute involving a . . . Return Amount, unless otherwise specified in Paragraph 13, the Valuation Agent will recalculate the Exposure and the Value as of the Recalculation Date by:
>
> (A) utilizing any calculations of Exposure for the Transactions . . . that the parties have agreed are not in dispute;
> (B) calculating the Exposure for the Transactions . . . in dispute by seeking four actual quotations at mid-market from Reference Market-makers for purposes of calculating Market Quotation, and taking the arithmetic average of those obtained; provided that if four quotations are not available for a particular Transaction . . ., then fewer than four

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> quotations may be used for that Transaction . . .; and if no quotations are available for a particular Transaction . . ., then the Valuation Agent's original calculations will be used for that Transaction . . .; and
> (C) utilizing the procedures specified in Paragraph 13 for calculating the Value, if disputed, of Posted Credit Support.
>
> [. . .]
>
> Following a recalculation pursuant to this Paragraph, the Valuation Agent will notify . . . the other party . . . not later than the Notification Time on the Local Business Day following the Resolution Time. The appropriate party will, upon demand following that notice by the Valuation Agent or a resolution pursuant to (3) above and subject to Paragraphs 4(a) and 4(b), make the appropriate Transfer.

In addition to these standard provisions, the parties' CSA states that "the provisions of Paragraph 5 [i.e., the dispute resolution mechanism quoted above] will apply." The parties also amended the standard dispute-resolution language to provide that the transfer of an Undisputed Amount "need not be made prior to the time that such Transfer need otherwise be made" pursuant to the disputed collateral call.

The Master Confirmation, in turn, states that, "Notwithstanding anything in the Credit Support Annex to the contrary . . . [Barclays] shall Transfer any Return Amount in respect of Transactions [i.e., pay any collateral call by BDC] not later than the Business Day following the Business Day on which [BDC] requests the transfer of such Return Amount." (There is no corresponding provision regarding BDC's collateral-posting obligation.)

The Collateral Calls

For most of the parties' relationship, Barclays had valued the Reference Assets for collateral purposes using prices from a service called LoanX. After Lehman's initial September 2008 bankruptcy filing, the market for the loans comprising the Reference Assets was in substantial decline, and Barclays began valuing the Reference Assets at a significant discount to LoanX prices,[1] resulting in a series of substantial collateral calls by Barclays to BDC.

What turned out to be the final flurry of collateral calls and payments between the parties began on Monday, October 6, 2008, as follows:

Date	Collateral Call	By	To	Payment
October 3	$19.05 million	Barclays	BDC	Amount and date unknown
October 6	$11.75 million	Barclays	BDC	$16.62 million on October 6
October 6	$40,140,405.78	BDC	Barclays	$5 million on October 8
October 8	$7.25 million	Barclays	BDC	$7.25 million on October 8
October 9	$13.25 million	Barclays	BDC	$13.25 million on October 9
October 10	$3.5 million	Barclays	BDC	None
October 14	$12.49 million	Barclays	BDC	None

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The Parties' Dispute Regarding BDC's October 6 Collateral Call

Although most of these collateral calls were by Barclays to BDC, the parties' dispute centers on BDC's $40 million collateral call to Barclays on October 6. Barclays responded with an e-mail stating, "We do not agree with this call. Please let us know if you want to invoke the dispute mechanism." BDC responded later that same day that it was "not seeking to invoke the dispute mechanism" and that its collateral call was independent of Barclays' October 6 collateral call, which "we will continue to address in accordance with the documents." Barclays responded, "We show that BDC owes Barclays, not the other way around."

Subsequent to these communications, it apparently was agreed in a telephone call on the morning of October 7 that Barclays owed BDC $5,080,000. Later that day, BDC wrote to Barclays that "we have not received payment [on the 10/6 collateral call], nor has Barclays exercised its dispute right. We remind you that pursuant to Paragraph 4(b) and Paragraph 5 of the [CSA], by 5:00 p.m. today Barclays must either pay the amount set out in the request or exercise its dispute rights." Barclays responded at 4:05 p.m. that it agreed to return $5,080,000, but Barclays did not make a payment to BDC that day – in any amount. Rather, on October 8, Barclays sent BDC a payment of $5 million – $80,000 less than discussed on the morning of October 7.

While Barclays' other collateral calls, and BDC's payments of them, continued in the background, BDC took three steps that culminated in a lawsuit:

- On October 8, BDC sent Barclays a notice that Barclays had failed to meet BDC's October 6 collateral call, and that unless that was cured within two business days, an Event of Default would exist as to Barclays.
- On October 13, BDC sent a notice to Barclays designating October 14 as the Early Termination Date for all of the parties' transactions based on Barclays' failure to meet BDC's October 6 collateral call.
- On October 17, BDC sent Barclays a settlement statement setting forth the amount BDC determined was due to Barclays as a result of the Early Termination and demanding that Barclays return all of BDC's posted collateral, net of the amount due – approximately $300 million.

The Lawsuit and the Court Decisions

On October 17, BDC filed a lawsuit against Barclays in the Supreme Court, Commercial Division, asserting claims for breach of contract and declaratory judgment based on Barclays' failure to pay the October 6 collateral call. Barclays later counterclaimed, asserting claims for breach of contract and declaratory judgment based on BDC's failure to pay Barclays' October 10 and 14 collateral calls.

In March 2012, after extensive discovery, both parties moved for summary judgment. Justice Eileen Bransten found (in August 2012) that there were issues of fact as to whether Barclays had invoked the contractual dispute-resolution mechanism, precluding summary judgment for either party. The court did, however, grant Barclays summary judgment on one issue. BDC had argued that the provision in the Master Confirmation requiring Barclays to pay any collateral call by BDC by a specified deadline overrode the contractual dispute-resolution mechanism. Thus, BDC contended, Barclays was required to pay any disputed collateral call in full, not merely post the undisputed amount, or, as BDC's expert described it, "pay first and dispute later." Justice Bransten rejected this argument, and granted summary judgment to Barclays solely on that issue. The court also denied BDC's summary judgment motion to the extent that it challenged Barclays' changed valuation methodology for the Reference Assets, finding that BDC had not specifically disputed any of the collateral calls on that basis (which was not strictly correct – BDC had been paying Barclays' collateral calls "under protest" for some time), nor had BDC terminated the Agreement on that

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basis. BDC contended that use of the dispute-resolution mechanism to challenge Barclays' methodology would have been futile, but the court held that it was mandatory, citing *VCG Special Opportunities Master Fund, Ltd. v. Citibank, N.A.*, 594 F. Supp. 2d 334 (S.D.N.Y. 2008), in which a federal court had rejected a similar argument.

Both parties appealed Justice Bransten's decision, and in October 2013, the Appellate Division, First Department held, in a 3-2 decision, that BDC was entitled to summary judgment on the grounds that Barclays had failed to either dispute BDC's collateral call or pay the undisputed amount.

Barclays then obtained leave from the Appellate Division to appeal to the Court of Appeals, which issued a decision on February 19, 2015. Although the Court of Appeals held that the language in the Master Confirmation "negates the Dispute Resolution procedure found in the CSA," it nevertheless found that there were questions of fact as to whether Barclays "complied with the undisputed amount provision," and "whether BDC received the full benefit of the amount it was owed when Barclays paid the $5 million and reduced the amount of its collateral call to BDC by the additional $80,000." The case has now been remanded to Justice Bransten, presumably for a bench trial. (As of this writing, no further proceedings have been docketed.)

Lessons for Derivatives Users

While the final chapter in this saga has not yet been written, it nonetheless already has provided some important lessons regarding the handling of collateral disputes involving OTC derivatives.

First, the BDC-Barclays dispute confirms that market participants continue to shy away from invoking the dispute-resolution mechanism in the standard-form CSA. Indeed, BDC's expert testified that she had hardly ever seen parties carry through the entire mechanism, including getting market quotations. BDC and Barclays both seemed to tiptoe around whether they were actually invoking it, declaring unequivocally that they had done so only after the fact. To some degree, this likely reflects an understandable reluctance on the part of market participants to undertake escalating measures when they are trying to come to a consensual resolution. Here, for example, the dispute affected a portfolio of multiple trades put in place over many years, which neither party was likely to unwind lightly.

Second, market participants continue to express frustration and dissatisfaction with various aspects of the CSA's dispute-resolution mechanism. Here, for example, BDC argued that invoking the dispute-resolution mechanism would have been futile as to its challenge to Barclays' new valuation approach and therefore never expressly invoked it in response to any of Barclays' multiple collateral calls. Such frustration is understandable, since the mechanism gives most of the power to the party making the disputed collateral call. All they need to do is recalculate the collateral call and then give notice of the new amount, which must be paid. There ordinarily is no further recourse or avenue of appeal if the party receiving the recalculated collateral call still does not agree with it. Indeed, as a practical matter, a disputed call will rarely, if ever, change substantially as a result of invoking the dispute-resolution mechanism. Yet the case law now makes clear that the potential futility of the mechanism is unlikely to be treated by a court as a viable excuse for not using it. A party facing a collateral dispute that is potentially large enough to make litigation worthwhile therefore must invoke the mechanism definitively and promptly or face the strong possibility that they will lose the ability to litigate the dispute at all, much less prevail. The only viable alternative seems to be for the party receiving the disputed call to take the potentially risky path of paying the call in full and then making a call of its own – which is what BDC effectively did, paying all of Barclays' calls, while also pursuing its dispute with Barclays regarding the October 6 call.

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There also appears to be significant dissatisfaction with the timetable mandated by the dispute-resolution mechanism. As BDC's counsel stated at the oral argument on the summary judgment motions, invoking the mechanism is "a bit like lighting a fuse or almost [like] a freight train." It has only two steps, which must be completed within roughly two business days (unless otherwise amended):

1. Before the close of business on the day after the problematic collateral call is made, but ideally as soon as a disagreement manifests itself, the disputing party gives the counterparty notice of the dispute and pays any "undisputed amount." The parties must then "consult" in an attempt to resolve the dispute.
2. If the parties fail to resolve the dispute through consultation by the "Resolution Time," defined as 1 p.m. on the business day after notice of a dispute is given, the party that made the collateral call is to recalculate the amount due using any undisputed valuations and the average of mid-market quotations from Reference Market-makers (subject to certain other parameters) and then notify the other party no later than 1 p.m. on the following business day. Upon demand following that notice or any consensual resolution, the party that received the collateral call must pay the recalculated amount.

For a massive derivatives portfolio like the one at issue in the BDC Finance case, this procedure arguably is unrealistically expedited. For this reason, in a situation where the contractual timetable is in fact impracticable, parties might consider contracting around the case law, as it were, through a standstill agreement that preserves both parties' rights while buying time to work through the process at a more reasonable pace. Otherwise, until another, better mechanism is developed, this "freight train" procedure is mandatory for any party that wants to preserve the option to litigate a dispute in the future.[2]

Third, the BDC-Barclays litigation illustrates the importance of making a clear record of invoking the dispute-resolution provision in an unambiguous manner so that a disputing party is positioned for potential litigation, even if it is simultaneously pursuing a consensual resolution. This requires parties to both communicate clearly about what is happening at every step and seek clarification of any ambiguity. It might well make for some stilted conversations and awkward e-mails, but it can save significant cost and aggravation down the line. For example, when paying one of multiple calls, a party must be absolutely clear about what call it is paying and why, and document any agreement to change the amount of the call, including whether that agreement was pursuant to or outside of the dispute-resolution mechanism, and, if so, whether it resolves the dispute or there is a remaining disagreement. Here, the record shows that both BDC and Barclays had a serious disagreement as to which litigation now seems foreseeable, and they also were trying hard to keep their options open. Barclays was, at best, muddled in communicating its intention to invoke the contractual dispute-resolution mechanism, seemingly in part because it was uncertain whether BDC had made a bona fide collateral call of its own or was merely disputing Barclays' collateral call made earlier that the same day. (In the litigation, Barclays argued that a dispute exists whenever both parties make collateral calls on the same day.) BDC, in turn, continued to negotiate with Barclays about its collateral calls while proceeding on a litigation-focused path with respect to BDC's own collateral call. The resulting confusion is illustrated vividly by the four significantly different pictures of the situation that emerge from the decisions of the three courts that considered it.

Conclusion

At the end of the day, a party hoping to preserve the option of litigating a collateral dispute would be well-advised to consider invoking the CSA's dispute-resolution mechanism early and definitively any time there is any meaningful disagreement about a collateral call, regardless of whether they ultimately plan to follow through with it or commence litigation. Of course, that is not a recipe for a harmonious relationship with a counterparty, but the practical realities and the existing case law counsel strongly in favor of it.

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[1] Barclays argued in the litigation that its methodology changed because market prices were falling faster than LoanX prices reflected, while BDC has argued that the change was designed to generate inflated collateral calls. **[2]** In response to these and other critiques, ISDA began in 2009 to develop a more robust and practicable collateral dispute-resolution procedure, but it did not get past the proposal stage.