KEY POINTS

- The standard of reasonableness for a discretionary valuation on close-out is that of rationality in accordance with *Wednesbury*.
- Whilst consideration of the valuation process itself is not obligatory, the court will consider the parties' evidence and submissions as to whether appropriate matters have been taken into, or left out of, account by the decision maker/valuer.
- Where a party has failed to carry out a discretionary valuation at the relevant time, the court will consider evidence as to what the party "*would have*" done at the relevant time.
- A valuation required to be made on the date of default or termination must be carried out immediately on that day, or the next business day.
- In circumstances where an asset cannot be sold immediately and there is no tangible bid in a relevant market, a zero valuation is theoretically possible.
- What a party "*would have*" done, should only include evidence of what the party *could* have done, in reality, if it were to have the time again.
- Detailed factual evidence should be adduced from the individual(s) who actually performed the valuation or would have done so.
- Expert evidence can provide a hindsight reality check on the valuer's own factual evidence, but cannot be a substitute for that subjective evidence, which should be tested in cross-examination.
- The instructions to expert witnesses should be carefully drafted to ensure that they accurately describe the expert's task, namely to consider the decision making party's evidence as to valuation, and should be annexed to their reports.

Author Barry Donnelly

Socimer International Bank v Standard Bank ten years on: the enduring lessons

Ten years after the Court of Appeal's judgment in *Socimer International Bank v Standard Bank*, the author (who advised Standard Bank throughout the litigation) reflects on the case, which remains an important guide to the urgent process of discretionary close-out valuation on counter-party default and how to prepare evidence in support or defence of the relevant decision making process.

INTRODUCTION

On 22 February 2008, as the financial crisis took hold, the Court of Appeal handed down judgment in favour of Standard Bank (Standard), in its five-year dispute with Socimer International Bank (*Socimer*) ([2008] EWCA Civ 116). The dispute concerned Standard's valuation, following Socimer's default, of a portfolio of emerging markets debt instruments (Designated Assets) which had been the subject of forward sales between the two banks. The seminal judgment in this leading case has since been mentioned, followed or approved in almost seventy cases (including in the Supreme Court),[1] and has been highly influential in the areas of contractual interpretation, implied terms, the duty of good faith, and discretionary valuations or decisions. The author advised Standard throughout the litigation.

In many ways, the real importance of the *Socimer* case has been overlooked. As this article explains, this is largely because many commentators have tended to focus on contractual discretion and good faith rather than the significance of the case to close-out valuations upon default, including the nature of the valuation exercise itself. Indeed, perhaps due in part to a lack of awareness of the Court of Appeal's second judgment, delivered on the day of handing down of the main judgment, the extent to which the court considered the process which would have been undertaken by Standard, in good faith, and acting rationally, at the relevant time, has not been appreciated. It is the examination of the valuation process evident from the Court of Appeal's second judgment which completes the picture in terms of the court's approach to discretionary valuations; it is not just the outcome of the decision-making process which is assessed, for rationality, but also the process of the valuation itself.

There are certain other important features of the case, including the evidential approach to discretionary close-out valuations on default. It is, therefore, instructive to re-visit the substance of the litigation.

BACKGROUND

The issues arose under the terms of Standard's Forward Sales Agreement entered into with Socimer on 8 November 1996 (FSA). Socimer would sell an emerging markets bond/instrument to Standard on a negotiated spot price basis, which Standard then agreed to sell forward to Socimer at a future date. Standard would pay over the agreed spot trade price to Socimer and receive in return a Downpayment (typically 30% to 50% of the spot price) to reflect the risk inherent in the Designated Asset which Standard might be left holding should Socimer default. The difference between the amount paid by Standard to Socimer and the Downpayment made by Socimer in respect of each Designated Asset was the "Unpaid Amount". This was calculated to include Standard's financing costs and fees. In effect, this Unpaid Amount represented financing obtained by Socimer for the forward sale period.

An important feature of these transactions was that pending settlement of a forward sale, Standard would have legal and beneficial ownership of the Designated Asset, which would be returned to Socimer upon the predetermined Settlement Date in return for the Unpaid Amount for that asset.

On 19 February 1998, Socimer defaulted by failing to make certain payments, and the

FSA was terminated on 20 February 1998. Standard was left holding a substantial portfolio of Designated Assets, including: US$10m face value of depositary receipts in an Argentinian entity, Socma (Socma DRs); and a huge number of minor Brazilian sovereign bonds known as TDA-Es (Brazilian TDA-Es).

Clause 14 (Events of Default) of the FSA contained the following provision at (a)(bb):

> "*The Seller may in its sole and absolute discretion sell the Designated Assets at such time, in such manner and at such price as it deems reasonable and appropriate.* 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." [Emphasis added]

Although the provision provided for Standard to *value* the Designated Assets on the date of termination, Standard did not consider that the Agreement required such a valuation; the clause (as highlighted above) also provided for Standard to *sell* the Designated Assets in its absolute discretion, at such time as it deemed appropriate. Indeed, Socimer itself did not suggest that an immediate valuation was required. As a result, Standard held the Designated Assets (it had no choice in the case of illiquid bonds), and then sold many of them over a period of time, accounting to Socimer for the net proceeds of sale.

On 3 March 1998, Socimer went into insolvent liquidation in the Bahamas. The court appointed Liquidator did not suggest that Standard should have valued the Designated Assets on termination, but received the net proceeds of sale of Designated Assets paid over by Standard, and eventually accepted a proof of debt submitted in the liquidation for an amount owing to Standard.

Four and a half years later, in November 2002, Standard received a letter before action from the Liquidator's legal representatives, claiming that Standard should have valued the Designated Assets on termination (20 February 1998), and that had it done so, a balance would have been owing to Socimer. Proceedings were subsequently commenced in April 2003.

In essence, Socimer claimed that Standard should have conducted a valuation on termination using available values, by reference to sources such as screen prices (if any) or Euroclear.

PRELIMINARY ISSUE TRIAL: TIMING AND ZERO VALUATIONS

Two important features of the litigation concerned the meaning of "on the date of termination" in the context of valuing a portfolio containing highly illiquid assets, and the possibility that the valuer may be justified in ascribing a zero value to certain assets.

Issues of construction of cl 14 were the subject of a preliminary issue trial in May 2004 ([2004] EWHC 1041 (Comm)). Cooke J held that Standard's "sole and absolute discretion [to] sell the Designated Assets at such time, in such manner and at such price as it deem[ed] reasonable and appropriate" only applied once it had done what was necessary to obtain a value for the portfolio. To that end, relying on the second sentence of the extract from cl 14(a)(bb) above, he found that Standard was obliged to sell, or retain and value, the Designated Assets on or immediately following the date of termination:

> "[T]he clause as a whole is designed to ensure that the calculation of the net position between Standard and Socimer takes place at or immediately following the termination of the parties' obligations, with immediate sale to third parties or retention by Standard, so that the existence of the surplus or deficiency is immediately obvious on the basis of the value of the assets as at the termination date." [at [31]]

Cooke J contemplated that valuation on the very date of termination (through a combination of actual and notional proceeds of sale) might not be possible, such as where termination occurred shortly before midnight (23.59 hours), in which case the valuation might have to be conducted after, but "as at", the termination date, on the subsequent day.[2] In fact, 20 February 2008 was a Friday such that it would not necessarily have been possible to value illiquid assets on that day; even the weekend, which coincided with carnival season in Brazil, could have been problematic in regard to the Brazilian TDA-Es, such that the following Monday might be required.

The judge also found that the valuation exercise lay "entirely in [Standard's] hands", and subject to the proviso that its assessment was "in good faith and [was] not challengeable on any other basis". Socimer's own case before Cooke J, which it called "tough on the buyer" (ie tough on Socimer) expressly acknowledged that to operate consistently with the purpose and intention of the FSA, the valuation had to be entirely within Standard's discretion and immediately on the date of termination.

Socimer, therefore, accepted before Cooke J that in the case of illiquid Designated Assets for which there was no value on a screen or elsewhere and which could not be sold/realised immediately (there was no bid in the relevant market), Standard could, if necessary, ascribe a zero value.

> "If the assets are truly liquid then … [Standard] can sell and the value it would ordinarily attribute, in good faith, to the Designated Asset would be the value actually realised. If the assets appear completely illiquid, then, in theory a zero valuation is possible." [at [32]]

Importantly, Standard had adduced evidence from Mr Ian Beckman, an expert with 25 years' experience in emerging markets debt, at this preliminary stage, which Cooke J accepted.

> "The expert's view was that … [t]he only definitive measure of value was … the price for which assets could actually be sold … [I]f there were no real buyers for the debt in the market and there was therefore no price at which the debt could be sold, it would be necessary to value the asset at zero." [at [7]]

WITNESS TRIAL: OBJECTIVE OR SUBJECTIVE TEST FOR VALUATION

Following the decision of Cooke J, the next stage of the litigation illustrates the vital part to be played by detailed factual and expert evidence in relation to the close-out valuation.

At a full witness trial before Gloster J in the summer of 2005, the primary focus was the conduct of the contractual procedure under cl 14 of the FSA. Standard's case was straightforward. Faced on the day of termination (or possibly the next business day) with a substantial portfolio of Designated Assets, some of which were highly illiquid, it would simply have had to do its best, using its own very experienced and senior staff. In particular, Mr David Feld (Director) and Mr Jeffrey Clifford (Senior Principal Trader) explained in detail in their witness statements how the valuation exercise *would have* been conducted by Mr Clifford in the first instance, and then immediately reviewed by Mr Feld with other members of Standard's Credit Committee, putting themselves back in their own shoes on termination. This approach gave effect to the proper construction of the FSA as found by Cooke J, and seemed obvious from *Cantor Fitzgerald International v Horulak* [2004] EWCA Civ 1287 (determination of an employee's discretionary bonus which the employer had failed to carry out).

Standard also recognised that in relation to particularly difficult and illiquid assets such as the Socma DRs and the Brazilian TDA-Es, it would, if possible, have contacted a specialist trader in those assets in the relevant country (ie Argentina and Brazil). Standard called relevant local evidence from a specialist trader in Buenos Aires, and a specialist trader and broker in Sao Paulo. To confirm Standard's own experienced valuations, a further expert witness report was served from Mr Beckman as to how, in his expert view based in London, Standard, in London, would have conducted the valuation.

Socimer, on the other hand, took an unexpected approach, despite its "tough on the buyer" stance before Cooke J. It submitted that Standard's evidence as to what would have happened was irrelevant and inadmissible, and it called independent expert evidence only. The effect of Socimer's evidence was to consider objectively, with the benefit of hindsight, what, in the experts' view, the "market value" or "fair value" of the relevant Designated Assets was at the date of termination (or over a period after termination).

Another feature of Socimer's stance on evidence, was deliberately not to challenge in cross-examination the detailed evidence of Standard's witnesses as to their approach to valuation.

In the Court of Appeal's judgment, it was not easy to state precisely the terms of the findings of Gloster J. This was particularly so in regard to the main issue, namely whether, as argued by Socimer, the FSA was subject to an implied term requiring Standard to carry out its valuation reasonably and with reasonable care so as to arrive at what objectively could be said to be a proper valuation of the Designated Assets. In this respect, the judge's expression of her decision was not uniform throughout her judgment. First, she found that the correct approach to the discretionary valuation was to establish what Standard "*would have*" done at the time (rejecting Socimer's application as to admissibility of Standard's key evidence). Consistently with the judgment of Cooke J, Gloster J also construed the express terms of the FSA as providing for an immediate discretionary valuation on the date of termination, performed by Standard as the chosen contractual "valuer", in good faith. However, the judge then accepted Socimer's case (which had never been pleaded or advanced prior to the trial before her) that the FSA was subject to an implied term as to "reasonableness" in the conduct of the valuation, meaning that the valuation had to be conducted in accordance with external criteria as to what was a reasonable "market value" at the time, judged not by Standard, but by external experts considering the matter years later with the benefit of hindsight.

In reaching her conclusions, Gloster J considered that the relevant unchallenged evidence of Standard's factual witnesses could fairly be rejected. In addition, the judge rejected the evidence of Mr Beckman as a cross-check or independent view of what Standard, in London, would have done, even though he was appropriately qualified and his evidence was effectively unchallenged.

In regard to Standard's Latin America based experts, the judge ignored the evidence in connection with the Socma DRs and rejected the evidence in regard to the TDA-Es. The judge ascribed her own value to the Socma DRs by reference to a sale by Standard in 2000, which would have had the effect of Standard losing US$1m, and accepted evidence from Socimer's expert on the Brazil TDA-Es which, in Standard's submission, involved complicated and manipulable processes called "unbundling" and "data cleaning" which were specially devised by the expert and were not standard industry methodologies.

THE COURT OF APPEAL: RATIONALITY PREVAILS

In overturning Gloster J's judgment, the Court of Appeal ([2008] EWCA Civ 116) made clear the subjective nature of decisions made pursuant to a power or discretion contractually allocated to one party, where that decision will have an effect on both parties.

> "[A] decision maker's discretion will be limited, as a matter of necessary implication, by concepts of honesty, good faith and genuineness, and the need for the absence of arbitrariness, capriciousness, perversity and irrationality. The concern is that the discretion should not be abused. Reasonableness and unreasonableness are also concepts deployed in this context, but only in a sense analogous to Wednesbury unreasonableness, not in the sense in which that expression is used when speaking of the duty to take reasonable care, or when otherwise deploying entirely objective criteria … [P]ursuant to the Wednesbury rationality test, the decision remains that of the decision-maker, whereas on entirely objective criteria of reasonableness the decision maker becomes the Court itself … For the sake of convenience and clarity I will therefore use the expression 'rationality' …" (at [66] per Rix LJ).

The Court of Appeal considered that when Gloster J explained her reasons, she confused or conflated the concepts of (objective) "reasonableness" and "rationality". For example, at para 40 of her judgment, the judge had stated:

> "In fact I do not view the obligation to act reasonably as anything in essence different from the obligation to use good faith; it is part of the good faith obligation that Standard should conduct the valuation process in a reasonable manner, to arrive at what objectively can be said to [be] a proper value of the Designated Assets at the termination date …" (see at [73]).

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It was noted in the lead judgment given by Rix LJ that Gloster J had given no reasons for rejecting Messrs Feld and Clifford's "*would have*" valuation evidence (at [86]).

As the Court of Appeal found, the correct approach was:

> "Mr [Stephen] Auld [QC]'s 'would have' obligation [which] was limited to that valuation which Standard was entitled to make in the exercise of its own discretion, in good faith and rationally, but otherwise consulting its own interests and therefore in that sense aiming at a subjectively valid as distinct from objectively true value."

In relation to Socimer's submission that Standard's expert evidence was introduced because it recognised that the correct test was an objective test, Rix LJ made specific reference to the experts' letters of instruction annexed to their reports. He noted how they had been asked to consider valuation from Standard's perspective. In Mr Beckman's case he was specifically instructed to place himself "in [Standard's] shoes" which "echoe[d] Cooke J's comment that the valuation exercise 'lies entirely in [Standard's] hands.'" (at [39]).

CONSIDERATION OF THE VALUATION EXERCISE: THE SECOND JUDGMENT

Although the full extent of the court's consideration of the detailed factual evidence submitted by Standard as to how it "*would have*" valued the Designated Assets is not reflected in the judgment of Gloster J, the evidence was read and reviewed in detail both at trial and on appeal.

In *Braganza v BP Shipping Limited* [2015] UKSC 17, the Supreme Court noted that the public law, *Wednesbury*, test of reasonableness involves two limbs:

- the decision making process and whether the contractual decision maker has left out of account matters which should be taken into account and vice versa; and
- whether, in any event, the conclusion is so irrational (unreasonable) that no rational decision maker could have reached it.

However, in *Lehman Brothers International (Europe) Ltd (In Administration) v Exxon Mobil Financial Services BV* [2016] EWHC 2699 (Comm), in the context of a "*would have*" valuation in relation to repo transactions under the GMRA, Blair J considered that the kind of analysis of the decision-making process appropriate in the public law context was not required.

In any event, valuation cases are bound to involve consideration of the valuation process. In *Socimer*, during a further day of argument, the Court of Appeal considered the consequences of its main judgment and received detailed submissions about Standard's "*would have*" valuation and the relevance of the supporting expert evidence.

> "So Mr Auld submits that Standard's case at trial was clear. The figures put forward were those of Mr Feld and his committee … Inasmuch as the expert witnesses that Standard have called gave valuations either above or below [Mr Feld's] figures … That was simply a hindsight reality check.
>
> [Mr Auld] says that it follows that there is nothing left for the parties to dispute, but for this court to adopt the valuations in respect of those two securities of Mr Feld as being Standard's would have valuations." ([2008] EWCA Civ 116 (No 2), at [14]-[15] per Rix LJ).

Understandably, what a party "*would have*" done, must only include evidence of what the party *could* have done, in reality, if it were to have the time again.

Socimer submitted that there should be a full retrial, at which it would seek for the first time to say that Standard's valuations "were evidenced in bad faith, would have been made in bad faith and were wholly irrational" (at [16]).

Socimer was given short shrift by Rix LJ:

> "In my judgement, that submission is a hopeless one. It amounts … to an abuse of process to ask this court to order a new trial upon a basis which has never previously been properly advanced …". (at [19])

In conclusion, the Court of Appeal ordered that Standard's unchallenged evidence of valuation, particularly in respect of the Socma DRs and the Brazilian TDA-Es (which were significant in the overall account between the parties) should be accepted.

After more than five years of litigation, and despite losing two trials, Standard was successfully restored to its position as a creditor in Socimer's insolvency. ■

1 See for example: *Lehman Brothers International (Europe) v JFB Firth Rixson* [2010] EWHC 3372 (in which the author advised *JFB Firth Rixson*); *WestLB v Nomura Bank International* [2012] EWCA 495 (in which the author advised *WestLB*); *Euroption Strategic Fund v Skandinaviska Banken* [2012] EWHC 584; *SNCB Holding v UBS* [2012] EWHC 2044; *Marex Financial Ltd v Creative Finance* [2013] EWHC 2155; *Torre Asset Funding v Royal Bank of Scotland* [2013] EWHC 3463; *Cukurova Finance International v Alfa Telecom Turkey* [2013] UKPC 25; *Deutsche Bank v Sebastian Holdings* [2013] EWHC 3463; *Brogden v Investec Bank* [2014] EWHC 2785; *Barclays Bank v Unicredit Bank* [2014] EWCA 302; *Braganza v BP Shipping* [2015] UKSC 17; *Mercuria Energy Trading PTE Ltd v Citibank NA* [2015] EWHC 1481; *Lehman Brothers International (Europe) v Exxon Mobil Financial Services BV* [2016] EWHC 2699; *Property Alliance Group v Royal Bank of Scotland* [2016] EWHC 3342; *LBI EHF v Raiffeisen Zentral Bank Osterreich* [2017] EWHC 522; *BHL v Leumi ABL Limited* [2017] EWHC 1871.

2 In recognition of this sort of problem, industry standard documents have been adapted to provide more flexibility.

Further Reading:

- Forward sale contracts: Valuation and implied terms (2008) 4 JIBFL 219.
- The expanding judicial review of contractual discretion: carte blanche or carton rouge? (2013) 5 JIBFL 269.
- LexisNexis Loan Ranger blog: Expert evidence to support or challenge Loss calculations: how credible is it?