

JURISTES, FISCALISTES & JURISPRUDENCE

MARGIN CALLS: How can investors protect their position?

...article by Matthias Gstoebl, Simone Nadelhofer, Nicolas Ollivier—LALIVE

INTRODUCTION

Following the recent market shakedown amidst the Covid-19 pandemic, banks have been issuing margin calls to their counterparties.

Who is affected? Broadly speaking, two types of investors: The first category are wealthy clients who have been investing in stock markets on a leveraged basis, through so-called Lombard loans, which are secured against a portfolio of liquid assets like equities and bonds. The other category comprises counterparties who have entered into derivatives transactions or secured lending agreements with banks.

In simple terms, a margin call is the demand by the bank to increase the collateral or to reduce the credit exposure of the bank by repaying a part of the loan.

In times that are already challenging enough, the margin calls have caught many investors off-guard. Banks typically allow not more than two days to top up the collateral. This often requires affected investors to source substantial liquidity amounts to meet the bank's request, which can prove difficult in the context of a general market sell-off.

The present contribution provides a brief overview of the legal framework and main issues arising under Swiss law, including the rights and remedies available to affected parties.

LEGAL FRAMEWORK

Primarily contractual provisions—In practice, lending transactions are subject to contractual freedom. Very few statutory provisions apply. In a lending transaction, the contractual documentation (“**Transaction Documents**”), typically consist of a (framework) credit facility agreement and of a (general) pledge agreement, in each case between a bank and a client. The Transaction Documents specify, inter alia, the following parameters:

- *The maximum credit amount or credit limit.*
- *The use the borrower can make of such credit amount:* for example, a current account overdraft, a fixed term advance, a guarantee or as margin cover for OTC derivative transactions (forwards, futures, options, swaps, etc.).
- *The eligible collateral:* this will ordinarily include all borrower's present and future assets, claims and rights deposited with the bank. The bank will often require

wide discretion to determine what eligible collateral is. It will typically be defined as cash, cash-equivalent assets or other assets acceptable to the bank (often time “at its sole discretion”).

The bank will not consider every type of collateral as equally eligible for lending. Indeed, the lending value or Loan-to-value (“**LTV**”) for an asset against which the bank is prepared to lend is calculated based on various risk parameters. The LTV is the ratio of a loan to the value of an asset, expressed in percentage. As a rule of thumb, assets with low volatility and/or high liquidity are considered safer than more volatile and illiquid asset classes. Hence, a diversified portfolio of stocks has a higher lending value compared to a single stock, while an investment grade bond portfolio has typically a higher lending value than an equity portfolio. Assets are valued on a “mark to market” basis, with daily valuations.

The Transaction Documents will also define the conditions under which the bank is entitled to issue a margin call. This will be the case, when the total outstanding amounts including accrued interest exceed the Lending Value of the collateral.

In general, borrowers can comply with the margin call by either selling collateral, by closing open positions (in derivatives), by supplying additional assets considered eligible collateral, or by providing funds.

If a borrower fails to honour the margin call, all outstanding amounts under the Transaction Documents automatically become due and payable. Accordingly, the bank is authorized to freely liquidate all collateral and to set off the liquidation proceeds against the outstanding amounts, or to close out open positions and/or transactions.

Obligations of the bank—Contractual provisions typically grant banks wide discretion at virtually every step in the lifecycle of a credit transaction, including for issuing margin calls. Nonetheless, the bank remains bound by certain restrictions when issuing a margin call and liquidating collateral.

Obligation to issue a margin call before liquidating the assets—Under certain standard clauses found in Transaction Documents, banks are authorized, but not obliged, to issue a margin call in order to inform the borrower about such shortfall and request immediate adjustment of the overdrawn position. Such provisions

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may conflict with the contractual provisions agreed between the parties in other asset management/advisory documentation, and with Swiss law, thereby overriding the standard clauses of the Transaction Documents.

Where the bank acts as a discretionary asset manager of the client, the duty of diligence and faithful performance (Art. 398(2) CO) dictates that the bank notifies the client of all important events in relation to the management mandate. In our view, this includes an obligation for the bank to inform the client of any margin deficiency. The bank is therefore required to monitor the collateral value and take the necessary measures, i.e. issue a margin call, in case of a collateral shortfall, not only to protect its own interests, but also to limit the risk of losses to the client.

The same holds true, when the parties are bound by a general advisory agreement, under which the bank provides only investment advice to the client, based on his or her risk profile. In our opinion, where a bank advises a client in relation to his or her portfolio, it also has the obligation to follow up on the changes in collateral value, issue a margin call where necessary and advise the investor to adjust the portfolio accordingly (by either selling positions to reduce the credit exposure or posting additional collateral).

The situation may vary if the bank provides only sporadic advice to the client. The Swiss Federal Supreme Court ruled that under such agreements, the bank is, in principle, neither obliged to monitor the client's portfolio nor to warn the client unless there is an express prior agreement or practice between the parties.

Consequently, even where the bank has contractually reserved its right to issue a margin call before liquidating the assets, it may nonetheless be obliged to do so based on the applicable investment agreements. In that sense, the margin call can be even considered a protecting mechanism for a borrower.

Whenever the bank issues a margin call, it must (i) indicate the amount of collateral called and (ii) set the time limit to post it. The Geneva Court of Appeal ruled that absent these prerequisites, the bank is exposed to liability.

Obligation to exercise its discretion with care—A typical contractual clause may read as follows: *“the Bank may at its sole discretion, at any time and without notice to the Borrower, adjust with immediate effect the percentage figures mentioned under “Lending Value”, “Margin-Call Level” and*

“Close-out Level” to reflect - in particular but not limited to - changes in economic, market or liquidity conditions”.

As a matter of principle, the Swiss Federal Court and scholars question whether it is at all permissible to grant a contractual party such broad discretion. In any event, the bank must always exercise its right to adjust the contractual parameters in good faith and not be abusive.

This is particularly true when issuing a margin call. In practice, the Transaction Documents are often silent on the detailed requirements for margin calls, the level of information required to communicate to the investor, and the rules applying to liquidation of assets, in particular, for those without tradeable price. In practice, banks communicate a collateral shortfall without further explanation to the clients. An investor is thus unable to understand, react and – most importantly – challenge the bank's calculation. This is particularly difficult given the time pressure they are under.

Under its obligations to provide an accounting, a bank must communicate to the borrower the calculation details and all relevant parameters of the margin call. Otherwise, the borrower will never be able to make informed choices, especially regarding steps required to protect his or her interests.

Obligation in connection with the liquidation of assets—When liquidating collateral, and although the bank may privilege its own interests, it still owes a duty of care and loyalty and is obliged to act in good faith and avoid damage to the borrower, provided this is compatible with the bank's own legitimate interests.

The prevalent view among authors is that the bank is not liable to the borrower for bad timing when liquidating collateral, i.e. where its value recovers after the liquidation. However, there may be arguably situations where the bank can delay or time the execution of the relevant selling order to minimize the impact on the market price. For instance, in highly volatile markets the liquidation should be spread over successive days. Also, for large positions, the liquidation strategy should aim at minimizing the volatility risks and market impact, according to the principle of best execution.

Finally, when selecting the collateral to be liquidated, the bank must take into account the requests of the borrower, if this is compatible with the bank's legitimate interests.

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Such requests are instructions that the bank must carry out according to the best execution principle.

Obligations of the bank in connection with liquidation of collateral

—Private liquidation vs. debt collection proceedings?

Where the collateral consists of intermediated securities, a liquidation of the collateral by the bank, outside of the framework of debt collection proceedings, is only permissible if the securities are traded on a representative market.

A market is considered representative if it allows to determine an adequate price that rules out the possibility of the borrower being overcharged. The specific requirements vary depending on the method of realization. Where the bank acquires the collateral in its own name (*Selbsteintritt*), stricter requirements apply than in the case of a sale to an independent third party.

—Obligation to exercise its rights moderately

In line with what has been said above, the Commercial Court of Zurich held that the exercise of a right to liquidate an asset may be considered abusive if it is detrimental to the other party and if it can be avoided by an alternative, less detrimental method that could achieve the same objective (Commercial Court of Zurich HG090170 of 22 August 2011).

—Obligation to provide an accounting

In connection with the liquidation of collateral, the bank must provide an accounting. This is relatively straightforward for exchange-traded securities (a transaction advice and internal bank documents indicating the exact time of the trade are generally sufficient). It is however more difficult for non-traded securities or derivative instruments, or where the bank acquires the collateral in its own name (*Selbsteintritt*). Here the bank owes the borrower an accounting of the liquidation procedure and parameters to value the options/derivatives (Geneva Court of Appeal ACJC/1515/2019 of 4 October 2019).

SELECTED ISSUES

Material Adverse Change—clauses—In more sophisticated situations, the relevant agreements will also include certain representations and warranties of the borrower and define certain events of default which may entitle the bank to

cancel the credit limit, declare all outstanding amounts due and payable, close-out open positions and liquidate the collateral. If any of the representations and warranties are breached, or any other close-out event or termination reasons occur, which the parties may have agreed separately, the bank may declare all loans due and liquidate the assets.

Among the events of defaults, certain credit agreements contain so-called material adverse change clauses (“MAC-clauses”): “*material adverse changes (for important reasons beyond the influence of the Bank, in particular if the Bank — at its sole discretion — considers that the Borrower’s financial status and/or earning situation has deteriorated considerably, or if the Borrower’s assets have become exposed to a major threat)*”.

The exercise of a discretionary right of determination must always be made in good faith and not be abusive. Also, the limit of Art. 27 para. 2 CC must be observed, which protects a contractual party against excessive commitment.

Especially in the case of MAC-clauses in loan agreements the bank must exercise the greatest restraint before it cuts off the borrower’s liquidity supply solely based on a material adverse effect alleged but disputed by the debtor.

Valuation inconsistencies—A recurring source of problems is the valuation of illiquid assets and derivative instruments, and of collateral that the bank acquires in its own name (*Selbsteintritt*).

Problems arise when the bank intends to acquire certain assets at a self-defined market value, which is not derived from the official closing prices, but in addition considers a set of non-transparent factors such as market impact, volatility and currency risk. These factors are not published on official data sources and are determined at the sole discretion of the bank.

In the same vein, in situations where the bank closes-out open derivative positions (or even where the client wishes to do so following a margin call), determining the market price of derivatives can prove a complex exercise. This is exacerbated by the fact that often the bank is at the same time lender and derivative counterparty.

Especially in bumpy markets, the bank will take different pricing assumptions (such as spreads or implied volatilities or currency exchange rates that are off-market), which may lead to distorted valuations.

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All these situations could be remedied if the parties contractually agreed in advance on a process for the liquidation of such assets and thereby largely contractualize the duty of care of the bank (e.g. number of quotes to be queried, designation of the market participants to be queried, selection of the valuation method including relevant parameters, transparency on all elements of the valuation, including any fees and commissions).

Impact of Covid-19—Certain banks may be tempted to invoke Covid-19 for triggering the application of MAC-clauses. To do so validly, the bank must demonstrate that the financial situation of the borrower has deteriorated due to Covid-19. A mere abstract assumption would not suffice, in particular when the borrower is a wealthy individual as opposed to a company in a sector particularly affected by the Covid-19 crisis.

By the same token, clients may invoke Covid-19 when faced with a margin call with very short notice to post collateral. In highly volatile markets and the current difficulties everyone is facing due to the various governmental measures (lockdown, clients stranded in foreign countries, etc.), the principle of good faith commands that the banks exercise their right with moderation, which is all the more a requirement when they know that clients will inevitably face a liquidity crunch or, more generally, difficulties in accessing funds to honour the margin call.

That said, the Covid-19 crisis will usually not meet the requirement to qualify as *force majeure* (see **Coronavirus: a force majeure event under Swiss law?**). Thus, it will not excuse a refusal to post collateral, at least as long as the financial infrastructure is still functional, funds can still be cleared and no measures on capital have been enacted.

AVAILABLE REMEDIES

Temporary restraint orders in order to allow a foreclosure of assets—A borrower who fears that the liquidation of his or her collateral is imminent and is unjustified may apply for a temporary restraint order with the competent court in Switzerland, prohibiting the bank to liquidate the collateral. The applicant must demonstrate that he or she has a credible claim on the merits, that the announced liquidation threatens to cause a harm not easily reparable and that the measure is urgent and proportionate.

According to the case law of the Commercial Court of Zurich, the threatened liquidation of shares may constitute in certain circumstances a harm not easily reparable. This is typically the case where an asset cannot easily be replaced by the borrower (following the liquidation) or where the liquidation would cause a damage that cannot easily be quantified (typically where the valuation of such asset is not straightforward).

Damages—Pursuant to Art. 31 para. 4 FISA, the bank is liable to pay damages to the borrower if it violates its statutory obligation to give advance notice of liquidation, either because it sets the time limit too short, or because the notice - without justification - is not issued at all. Also, investors may in some circumstances claim damages for breach of the contractual duties to inform, to warn, or to act with due diligence, as well as for breach of best execution duty. Excessive commissions, miscalculations, misevaluation of the OTC derivatives may also give rise to damages claims.

(No) influence of standstill on debt collection?—On 18 March 2020, the Swiss government issued a general stay on debt collection proceedings as part of its measures to support the economy in the wake of the Covid-19 pandemic.

If the collateral comprises intermediated securities and to the extent that the agreement is silent and does not foresee a liquidation via private sale (or the same is not possible for other reasons), the stay would provide a temporary relief to borrowers.

In practice however, most banks reserve the liquidation of collateral via private realization as opposed to debt collection, so that this temporary relief would apply only in exceptional circumstances.

KEY TAKEAWAYS & RECOMMENDATIONS

Based on the above, investors are advised to take the following steps when faced with a margin call and/or a liquidation of collateral by the bank.

Request parameters and calculation details—The first measure is to immediately request the bank for the calculation details of the margin call and a valuation of any derivatives positions. This will help the investor to understand and assess whether the collateral required is

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effectively due and whether the bank has abided by its obligations and exercised its rights correctly.

If possible, honour the margin call and reserve your rights—It may often be complicated to fully assess the situation due to the time constraints and the imminent threat of liquidation of assets. Under Swiss law, a claimant is obliged to mitigate its damage. Consequently, we advise investors wherever possible to honour the margin call, even in situations where they contest the bank's position. The investor should however highlight the relevant breaches and expressly reserve all rights to avoid any implied waiver of rights and ratification of any potential breaches committed by the bank.

Object in writing to the margin call, the liquidation and the corresponding transactions and resulting balances—Where honouring the margin call is not possible, clients

should swiftly object to the margin call, the subsequent liquidations and all corresponding transactions carried out on the accounts, as well as the current and former account balances. Such objection must be notified in timely fashion to the bank in writing, typically within 7 to 30 days, in accordance with the relevant contractual provisions.

* * *

The above measures allow to assess the merits of legal action against the bank, be it in form of damages or other type of recourse. In any case, a timely reaction as soon as a margin call is received will allow an investor to protect his or her position.

BIOGRAPHIE DES AUTEURS



Matthias Gstoebl, Partner

Matthias Gstoebl joined LALIVE in 2017. He specialises in complex, often multi-jurisdictional, proceedings, including asset recovery, fraud and white collar crime, recognition and enforcement of foreign judgments and awards, international mutual assistance, FINMA enforcement proceedings and bank insolvency. Matthias Gstoebl's activity strongly focuses on banking and finance disputes. With first-hand experience in the financial sector, he handles complex cases requiring specialist knowledge in derivative instruments, hedge funds and other financial products. He also regularly acts for clients in contentious corporate, commercial and private client matters (primarily successions and trusts). Matthias Gstoebl is a member of the Zurich Bar Association (ZAV), the Swiss Bar Association (SAV), the International Bar Association (IBA), the Swiss Arbitration Association (ASA), the International Association of Young Lawyers (AIJA) and the International Association of Restructuring, Insolvency & Bankruptcy Professionals (INSOL). Matthias Gstoebl studied law at the Universities of Vienna and Geneva (lic. iur, 1998), and completed postgraduate studies in Finance at London Business School (MSc in Finance, 2006).



Simone Nadelhofer, Partner

Simone Nadelhofer joined LALIVE in 2009 and is a partner based in our Zurich office. She specialises in white collar crime and regulatory investigations and advises clients on crisis management, compliance and remedial action, as well as cross-border investigations by Swiss and foreign authorities. She also assists clients in international legal and administrative assistance, as well as victims of crime in tracing and freezing of assets. Simone Nadelhofer regularly acts as counsel in complex commercial and banking disputes before state courts. Simone Nadelhofer is a member of the Swiss Association of Experts in Economic Crime Investigation, the Zurich and Swiss Bar Association and the European Criminal Bar Association (ECBA). She is Regional Representative Europe of the IBA's Business Crime Committee, Chair of the Anti-corruption and the Rule of Law Committee at the Inter Pacific Bar Association (IPBA) and a member of the advisory board of the Master Economic Crime Investigations studies at the Lucerne University. Furthermore, Simone Nadelhofer acts as the external ombudsperson for tesa SE. Simone Nadelhofer holds a PhD, summa cum laude, from the University of Lucerne.



Nicolas Ollivier, Counsel

Nicolas Ollivier joined LALIVE in 2012. He specializes in banking and finance. He regularly advises and represents clients in complex cases such as margin calls, improper execution of orders, mismanagement, fraudulent transfer orders, cross-border issues, bank bankruptcy, freezing of accounts as well as in relation to administrative and enforcement proceedings before the Swiss Financial Market Supervisory Authority (FINMA). He is a member of the Association Genevoise du Droit des Affaires, the Geneva Bar Association and of the Swiss Federation of Lawyers. Before joining LALIVE, Nicolas Ollivier worked as an associate with FBT Avocats SA, in Geneva, in the banking group (2011-2012). He previously trained with Boivin & Nussbaumer in Fribourg (2005-2007). Nicolas Ollivier graduated from the University of Fribourg with a Master of Law, majoring European Law (2004) and holds an LL.M from the University of Durham (with Distinction) (2010).