TEIGLAND-HUNT LLP

CLIENT ALERT
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The Wrong Way to Dispute a Collateral Call

-- Key Lessons from *VCG vs. Citibank*

Summary

In a recent decision providing important reminders for participants in the OTC derivatives markets, a New York federal district court judge ruled in favor of Citibank, N.A. ("Citibank") in a case brought by one of its hedge fund clients. Notably the judge ruled that VCG Special Opportunities Master Fund Limited ("VCG") had, by its conduct, effectively waived its right to claim that Citibank wrongfully demanded additional collateral in respect of a credit default swap. Although VCG maintained that it repeatedly questioned the valuations supporting Citibank's demands, the court held that VCG was prevented from challenging Citibank's calls because:

(1) VCG had continued to post additional collateral in response to the calls made by Citibank; and

(2) VCG failed to invoke the dispute resolution mechanism contained in the ISDA Credit Support Annex between the parties.

Key Practice Points:

When disputing a margin call under ISDA's standard Credit Support Annex (New York law) ("CSA"), a party should:

- **specifically invoke the CSA's dispute resolution mechanism; and**
- **either: (1) withhold the disputed portion of the call until the dispute resolution mechanism has been allowed to operate in accordance with the CSA; or (2) if the disputing party chooses to post the disputed amount of a call prior to completion of the dispute resolution process, make clear that the posting is being made under protest and does not constitute a waiver or modification of any of its rights under the ISDA Master Agreement or applicable law.**

Background: The CDS Transaction between VCG and Citibank

A hedge fund known as VCG sued Citibank earlier this year in connection with a credit default swap ("CDS") transaction executed between the parties in July 2007. Specifically, VCG had sold Citibank credit protection in respect of Class B Notes issued by Millstone III CDO Ltd. III-A. Citibank agreed to make periodic fixed payments of 5.50% per annum on the initial face amount of the Class B Notes covered by the swap in return for VCG's agreement to pay Citibank a "Floating Payment Amount" upon the occurrence of certain specified credit events (each, a "Floating Amount Event").

Upon entering the swap, VCG posted a certain amount of collateral as an "Independent Amount" (i.e., initial margin) with Citibank. Shortly after the transaction was executed, Citibank made four separate calls for additional collateral (i.e., variation margin) under the terms of the CSA due to the deteriorating value of the Class B Notes. These calls, all of which were met by VCG, effectively required VCG to post collateral exceeding $9.9 million, or nearly the entire $10 million notional amount of the swap.

A few months later, in January 2008, Citibank determined that a Floating Amount Event (based on an "Implied Writedown") had occurred under the swap and demanded that VCG pay the Floating Payment Amount. VCG disagreed and sued Citibank in February 2008 claiming, inter alia, that not only had a Floating Amount Event not occurred, but also that Citibank had wrongfully made excessive collateral calls during the life of the trade. VCG argued that, although it delivered the collateral requested by Citibank, VCG repeatedly questioned Citibank's calculations of the additional credit support due under the contract. VCG maintained that it nonetheless delivered the additional credit support to Citibank out of concern that Citibank might use VCG's refusal to post the variation margin as a reason to declare a technical default and seize the collateral VCG had already posted.

The Decision: VCG Had Waived Its Right to Claim for Excessive Collateral Calls

The court rejected all of VCG's claims and granted judgment to Citibank on the pleadings. Significantly, the court held that VCG had waived its right to make a claim for improper collateral calls in light of VCG's continued agreement to post the additional collateral requested and its acceptance of periodic payments from Citibank under the swap. Given this conduct, the court stated, "VCG cannot now claim that Citibank breached the CDS Contract by wrongly demanding additional collateral."

In addition the court made special note of the dispute resolution provisions in the CSA and VCG's concession that it had failed to invoke them. VCG had argued that it would have been meaningless to invoke the CSA's dispute resolution mechanism because the parties were still discussing the variation margin issues when Citibank declared that a Floating Amount Event had occurred. In response the court cited New York public policy favoring alternative dispute resolution mechanisms (assuming they reflect the informed negotiation and endorsement of the parties). On that basis the court ruled that "VCG cannot now challenge Citibank's request for additional collateral without having first vetted this claim in the manner agreed upon" in the CSA. Therefore, VCG's claim that Citibank wrongly demanded variation margin failed.

Implications of the Decision for Market Participants

The decision in *VCG vs. Citibank* is a clear reminder of the importance of properly reserving one's rights in a collateral dispute. In addition, whenever a party disputes a counterparty's call for collateral or margin, it is essential that the disputing party be mindful of the provisions of the parties' trading documentation that may be relevant to the dispute. If the parties have agreed to a dispute resolution mechanism, New York courts generally will expect a disputing party to invoke that mechanism to resolve the dispute before resorting to New York courts.

Under ISDA's standard form of CSA, a disputing party must (1) timely notify the other party (and the Valuation Agent if necessary) of the dispute in writing; and (2) transfer the *undisputed* amount of the margin call in a timely manner. The parties are then required to attempt to resolve the dispute between themselves. If the parties are unable to resolve the dispute by the "Resolution Time" specified by the parties in the CSA, a specific mechanism for resolving the dispute will then apply (depending on the nature of the dispute).

Failure to follow the dispute resolution mechanism set forth in the CSA may cause a disputing party to lose its right to dispute collateral calls in the New York courts. Should a disputing party choose to post the disputed portion of a collateral call (contrary to the provisions of the CSA), it should clearly do so under protest and reserve its legal rights in writing.

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If you have any questions regarding the above or would like further information, please contact one of the following:

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