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CLIENT ALERT

Calculating Your Loss When a Trade Breaks

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Illiquid assets that trade in the secondary credit markets are often difficult to value. Calculating economic loss when a counterparty defaults on a trade requires a comparison between the original trade price and the fair market value of the asset on the date of breach. That poses a challenge for traders and their in-house counsel when deciding whether it makes economic sense to pursue litigation against a defaulting counterparty. Valuable time may be wasted if there is a singular focus on liability, rather than damages, during the initial sparring. Understanding how much money is at stake can lead to sound decisions as to whether to litigate, and ultimately, the best path forward.

When a trade breaks, the non-defaulting party holds a litigation damages claim. (Whether a court can compel a defaulting party to actually perform the intended trade is under the doctrine of specific performance and is beyond the scope of this article.) If the non-defaulting party is the seller, the risk of ownership is once again its to manage (perhaps by re-selling), and if the non-defaulting party is the purchaser, it may decide to enter into a replacement (or "cover" trade). But either way, business and legal personnel of the non-defaulting party must work hand-in-glove to gather relevant damages evidence and estimate recoverable damages arising out of the broken trade and the resulting litigation claim.

Today, we offer guidance on how to undertake that damages assessment and a general framework for the analysis. (In prior Roads to Recovery articles, we addressed whether your counterparties' oral agreements are enforceable and what essential matters a party should focus on when the trade is breaking.)

For trades governed by New York law, the threshold question is whether the trade is enforceable by its terms and whether a court will treat it as a final binding trade. If the trade involves a syndicated bank loan that is subject to a standard-form trade confirmation, a court is likely to find that the parties had an obligation to close. If so, then the default measure of damages under New York law is the difference between contract price and fair market value measured as of the date of breach. But determining fair market value as of that date may not be easy.

In-house counsel should consider real time market data relevant to fair market value, including completed trades of the same asset in like quantities. However, credits such as distressed loans, bankruptcy claims and post-reorganization equity are often thinly traded, on bespoke terms, and in illiquid markets—particularly if the loans are part of a small facility or the bankruptcy claims are of any unusual type—which may limit the usefulness of market data. Market disruptions such as those we are currently seeing may impact the frequency and volatility of trading. There may also be bids and asks in the market but no completed trades, which generates the appearance of prices but no real evidence. Furthermore, post-reorganization equity may include control rights over new companies that are difficult to value.

In a litigation context, proof of fair market value may ultimately depend on an expert's assessment of "hypothetical market value" based on where a willing buyer and seller would transact assuming no compulsion to trade, with each party having knowledge of relevant facts.

Even if the trade is not enforceable as a fully binding agreement, a defaulting party to a trade governed by New York law may still violate a duty to negotiate final settlement terms in good faith.

To assess damages for a broken trade that is not subject to a fully binding agreement, a court may apply a reliance measure of damages, *i.e.*, the harm suffered by the non-defaulting party in reliance on the promise to work towards settlement. Counsel should work to identify opportunities that were passed on and the evidence supporting that assertion. For example, if a market participant is investing in a specific class of bankruptcy claims and decides not to bid on a second portfolio of like claims because it has already allocated capital to the initial trade, it may have a viable reliance claim if the first trade breaks. Non-defaulting parties may also be entitled to recover out-of-pocket costs, such as legal fees and costs.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.