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Expert Analysis

Court Confirms Hedge Funds Did Not Act In Bad Faith, Affirms Large Judgment

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In *Good Hill Master Fund L.P. v. Deutsche Bank AG*, No. 600858/10-2188B, 2017 BL 19363 (App. Div. 1st Dep't Jan. 24, 2017), the Appellate Division, First Department, unanimously affirmed a judgment entered in the Commercial Division of over $90 million, a large portion of which included prejudgment interest at 21 percent. The judgment followed a nonjury trial before Justice O. Peter Sherwood of the New York County Commercial Division. The case was brought by two hedge funds against Deutsche Bank in connection with credit default swap (CDS) agreements. The First Department rejected the bank's arguments that the hedge funds acted in bad faith by renegotiating the terms of the underlying securitized notes to the detriment of their CDS counterparty, Deutsche Bank.

Background

In 2007, two hedge funds, Good Hill Master Fund L.P. and Good Hill Master Fund, H.L.P. (collectively, Good Hill) purchased several tranches of notes from Bank of America in a securitization that was backed by $10.3 billion of residential mortgage-backed securities. Of the notes that Good Hill purchased, only one tranche was investment grade, tranche B6. *Good Hill*, 2017 BL 19363, at *1. In early 2008, Good Hill executed CDS agreements for the B6 tranche with Deutsche Bank under which Good Hill was obliged to pay Deutsche Bank if a "floating amount event" occurred. The CDS agreements consisted of a 2002 International Swaps and Derivatives Association (ISDA) Master Agreement and 2003 ISDA Credit Derivatives Definitions. A "floating amount event" could occur, among other things, upon the writedown of the B6 notes—i.e., if the noteholders forgave any part of the principal due. Id. at *1-*2.To purchase the CDS, Deutsche Bank paid Good Hill $12.8 million up front, and $1.5 million in total monthly payments. Good Hill posted collateral up front to secure its obligation under the CDS.

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Due to the economic downturn in 2008, Bank of America offered to repurchase from Good Hill the notes that Bank of America did not already own in order to facilitate an unwinding of the securitization. Bank of America and Good Hill ultimately negotiated a price of $0.29 on the dollar for all of Good Hill's notes, including B6, which was the tranche for which Good Hill had provided CDS protection to Deutsche Bank. Good Hill asked Bank of America to allocate the total purchase price for all its notes to the B6 notes. This action would have resulted in repayment of the majority of the B6 notes without a significant writedown, and would have avoided triggering a "floating amount event" under the CDS contracts. Id. at *2. Bank of America agreed to allocate 83 percent of the purchase price to the B6 notes, and only 17 percent of the principal on the B6 notes was forgiven.

In August 2009, Deutsche Bank informed Good Hill that it considered the repurchase of the notes to amount to a writedown of the principal and that a floating amount event under the CDS had therefore occurred. The CDS agreements required Deutsche Bank to calculate the floating amount based on reports issued by the entity

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that serviced the loans. Deutsche Bank refused to rely on the servicer reports because it considered the allocation of purchase price to the B6 notes principal to have been “allocated in a manner that appears to be potentially arbitrary and inconsistent with [Deutsche Bank’s] understanding of market valuation” of the notes. Id. at *3.

Good Hill disagreed and instead requested a return of its collateral, calculating that it owed Deutsche Bank $5 million and asserting that Deutsche Bank was overcollateralized on the CDS by $22 million. Deutsche Bank responded that it had “serious concerns that the arbitrary allocation” of the repurchase price from Bank of America was designed to avoid a floating amount event. Deutsche Bank refused to return the collateral. Id. Good Hill responded that the applicable agreements did not bar it from negotiating the allocation of the repurchase price with Bank of America. It cited to §9.1(b)(iii) of the 2003 ISDA Credit Derivatives Definitions, which provided in relevant part that the parties “may act with respect to such business in the same manner as each of them would if such Credit Derivative Transaction did not exist, regardless of whether any such action might have an adverse effect on … the position of the other party to such Credit Derivative Transaction or otherwise.” Id. at *4.

Deutsche Bank’s refusal to return the collateral prompted Good Hill to file suit in the Commercial Division. The suit alleged a breach of contract based on Deutsche Bank’s failure to return the collateral. Deutsche Bank countered that Good Hill had violated its obligations in connection with the CDS agreements to act in good faith and in a reasonably commercial manner by structuring the repurchase price with Bank of America so it applied to the repurchase of the B6 tranche. Id.

Decision

Following a bench trial, the Commercial Division ruled in Good Hill’s favor, concluding that Good Hill had acted in good faith, and that Deutsche Bank had breached the CDS agreements by refusing to return Good Hill’s collateral. The First Department stated that it found “no basis to disturb” the Commercial Division’s determination that Deutsche Bank had breached the contracts. Id. The court affirmed the Commercial Division’s finding that “Good Hill negotiated at arm’s length with Bank of America” and that Bank of America was free to accept or reject the allocation of the purchase price to the investment grade notes. Id. The First Department further concluded that Good Hill had not violated any of the CDS governing agreements. The court noted that pursuant to the governing agreements, Good Hill could “pursue its own interests, even if it might have an adverse effect on [Deutsche Bank].” Id.

The First Department also affirmed the Commercial Division’s award of prejudgment interest pursuant to the contract rate provided for in the ISDA 2002 Master Agreement. The 2002 ISDA Master Agreement defined the contractual interest rate for prejudgment interest as cost of funds, certified “without proof or evidence of any actual cost,” plus 1 percent. Good Hill proffered a certification from its Chief Financial Officer stating that the borrowing costs amounted to 20 percent per year. Accordingly, Good Hill requested a 21 percent interest rate. Deutsche Bank challenged Good Hill’s certification that the borrowing costs were 20 percent and contended that Good Hill could have obtained a more favorable rate. Deutsche Bank sought to introduce evidence that actual borrowing costs were much lower. The Commercial Division accepted Good Hill’s certification that its borrowing costs were 20 percent per year *without requiring any further proof*. The First Department agreed with the Commercial Division that the governing agreements required only a certification of borrowing costs and did not require proof or evidence of *actual* borrowing costs. Id. at *5. The First Department recognized that “the resulting judgment is large relative to the original award,” but that “this is no reason to depart from the legal principle that contracts must be enforced according to the language adopted by the parties.” Id. (internal citation and quotation marks omitted).

Significance

The First Department’s decision in *Good Hill* has potentially broad implications for participants in the CDS market. The decision is important because the court held that the 2003 ISDA Derivatives Credit Definitions permitted Good Hill to negotiate aggressively and pursue its own interests, even to the detriment of its CDS counterparty. The decision is also significant because the court held the parties to the methodology for calculating prejudgment interest that was set forth in the contracts even though it yielded a judgment that was more than three times the amount of the original award.