AMERICAN AND ENGLISH PERSPECTIVES ON CDO LITIGATION

London, March 2008
CDOs and the “Sub-Prime” problem?

• What is the fuss about?
• Global CDO Market Issuance
  • 2004: $157 billion
  • 2005: $271 billion
  • 2007: $412 billion
• The Sub-Prime Trigger
  • $500-600 billion globally expected to be written off against the value of sub-prime mortgages
• But, not just a “sub prime” issue
• Broader credit crisis: ratings downgrades & forced liquidations
• Few financial institutions unscathed
• Litigation: imminent
• The worst is yet to come?
CDO Litigation Theories

• What triggers litigation:
  • Unexpected and large potential losses
  • Tripping of over-collateralization or similar tests
  • Disagreement over appropriate priority of payments
  • Liquidation of portfolio assets
  • Collateral calls
  • Poor documentation: ambiguity = opportunity
  • Unwillingness to compromise, or inability to do so – due to encumbered balance sheet
  • In our view: all bets are off and virtually every action (or even inaction sometimes) carries litigation risk
CDO Litigation Theories

Who brings the claims:

- CDO investors
  - Senior Note holders vs. Income Note holders
  - Institutional vs. individual investors
  - Hedge funds/ fund investors.
  - Liquidators and trustees of insolvent CDOs
- Swap counterparties
- Mono-line insurers
- Warehouse agents
CDO Litigation Theories

• **Who gets sued:**
  – Placement agents/underwriter
  – Portfolio managers
  – Financial advisors
  – Administrative agents
  – CDO directors and officers
  – Rating agencies
  – Mono-line insurers
  – Accountants
  – Other professionals? Law firms?
U.S. Claims

• What are the claims
  • Sales Practices:
    – Misrepresentations and omissions
    – Collateral contracts/promissory estoppel
    – Suitability
  • Federal securities fraud claims
  • Mismanagement; Breach of fiduciary duty
  • Breach of contract
    – Contract interpretation
    – Third party beneficiary standing
  • Aiding and abetting breach of fiduciary duty/fraud
  • Civil conspiracy
  • Class actions ??
English Claims

• What are the Claims?
  • Deceit
  • Misrepresentation (if contract) – innocent/negligent/fraudulent
  • Breach of contract: contract term/IMPLIED term (reasonable skill and care in management of funds)
  • Negligent mis-statement (if no contract)
  • Breach of a duty of good faith/duty to inform
Mis-selling: Disclosure

- Relevant predominantly to arrangers and investors
- Raises important issues relating to:
  - An entity’s obligation to disclose information to another party
  - The duties owed and the distinction between providing advice and information
  - The effect of entire agreement and disclaimer of reliance clauses
- Duty to disclose
  - *IFE Fund SA v Goldman Sachs International* [2007] All ER (D) 476 (Jul)
    - Not a CDO case but most recent CA decision on relevant issues
    - Relevant to institutions who arrange and syndicate credit facilities
    - IFE alleged that GSI had a duty to provide information
    - IFE alleged an implied representation by GSI that it knew nothing which showed that the Information Memorandum was or might be materially incorrect.
    - CA held no “duty of disclosure” and no “implied representation” as pleaded (See Exhibit 2)
Mis-selling: Advising and Explaining

• Distinction between advising and providing information (see IFE case)
  • Court – reluctant to impose duty to provide information unless entity is providing advice or other professional services
• Avoid giving “advice” otherwise potentially liable
  • Requires an assumption of responsibility
  • Accepting invitation to give advice – strong indication of assumption
• No duty to explain (eg risks) – sophisticated investors
Mis-selling: Disclosure and Disclaimers

New York law summary:

• “where a party specifically disclaims reliance upon a particular representation, that party cannot, in a subsequent action for common law fraud, claim it was fraudulently induced to enter into a contract by the very representation it has disclaimed reliance upon.”

• Disclaimer must be specific such that it “tracks the substance of the alleged misrepresentation.”

• General disclaimers alone - unlikely to suffice.

• In addition to the disclaimer terms, courts will examine “the entire context of the transaction, including factors such as its complexity and magnitude, the sophistication of the parties, and the content of any agreements between them.”
Mis-selling: Disclosure and Disclaimers

- *Danann Realty Corp. v. Harris (NY Ct. App.)*
  - A party, having expressly disclaimed reliance on representations not included in the contract, cannot claim fraud in the inducement of the contract on the strength of oral representations.
  - Plaintiffs’ purported reliance on oral representations was negated by a specific disclaimer that expressly disclaimed reliance on “any statement or representation not embodied in the [final contract].”
  - The rule in *Danann* has been followed closely by state and federal court in New York over the past four decades.
- **But:** Growing body of US case law that provides exceptions to the rule in *Danann*. 
Mis-selling: Disclosure and Disclaimers

- Disclaimers must be specific in order to be effective.
- Exception to Danaan is invoked successfully by individual investors but also, on occasion, by institutional investors.
- Caiola v. Citibank (2d. Cir.)
  - “A disclaimer is generally enforceable only ‘if it tracks the substance of the alleged misrepresentation . . . .’”
- Mfrs. Hanover Trust Co. v. Yanakas (2d. Cir.)
  - A valid disclaimer “must contain explicit disclaimers of the particular representations that form the basis” of the claim.
Mis-selling: Disclosure and Disclaimers

*De Kwiatkowski v. Bear, Stearns & Co., (S.D.N.Y./2d Cir. 2002)*

- 2d Circuit reversed a jury verdict of $165 million in favor of sophisticated currency trader.
- **Held**: Bear Stearns owed no duty of care to plaintiff to render market advice and issue risk warnings on an on-going basis.
- In a non-discretionary account, “the broker ordinarily has no duty to monitor a nondiscretionary account, or to give advice to such a customer on an ongoing basis.”
- “The broker’s duties ordinarily end after each transaction is done, and thus do not include a duty to offer unsolicited information, advice, or warnings concerning the customer’s investments.”
- Court undertook detailed review of plaintiff’s dealings with Bear and concluded that “special circumstances” did not exist.
Mis-selling: Entire Agreement and Disclaimers

- May be included in (eg) investor presentations, term sheets, offering documents/IM’s and ISDA agreements

- English Court approach
  - Clauses need to be drafted to cover the situation in question
  - *Alman v Associated Newspapers Ltd* (20 June 1980, unreported). The clause provided simply that the written contract constitutes 'the entire agreement and understanding between the parties'. Browne-Wilkinson J held the clause was ineffective to exclude liability for misrepresentation. It did not refer to pre-contract representations.
Mis-selling:
Entire Agreement and Disclaimers

• 1986 Law Commission statement is of note:
  – “An entire agreement clause may have a very strong persuasive effect but if it were proved that notwithstanding the clause, the parties actually intended some additional term to be of contractual effect the court would give effect to that term because that was the intention of the parties.” (Law Commission Report No. 154 para. 2.15).

• Exclusion clauses require clear wording to exclude a liability which would otherwise arise (Gilbert-Ash (Northern) Limited v. Modern Engineering (Bristol) Limited [1974]
Mis-selling:
Entire Agreement and Disclaimers

• Practical impact
  • See IFE (Exhibit 2)
  • A comprehensive clause provides the certainty that there is no need to consider the possibility of further terms beyond those stated in contract.
  • Can avoid assumption of responsibility
Mismanagement
Duty of reasonable care and skill

- Relevant to managed CDO’s (as opposed to static CDO’s)
- Issues predominantly affect collateral/portfolio manager, the SPV and investors
- US: *HSH Nordbank v. UBS* (complaints about changes in the composition of the portfolio)
- General complaints relate to:
  - Alleged failure to purchase investments which match eligibility criteria, portfolio diversity and/or quality tests
  - Undervaluation of assets when selling collateral
  - Overvaluation of assets when acquired from warehouse
- Who sets the standard of care? “Industry practice?”
Mismanagement
Duty of reasonable care and skill

- Duty/standard of care
  - Duty of reasonable care and skill in provision of professional services
  - Express duty?
  - Implied by statute eg S.O.G.S.A. 1982?
  - Standard of care and skill expected of a professional: “that which is reasonably to be expected by a member of his profession of ordinary competence and experience” (*Bolam v. Friern Hospital Management Committee*)
**Mismanagement**
**Duty of Good Faith**

- **Is there a duty of good faith?**
  - Claimants claiming existence of a duty of good faith, eg. *HSH Nordbank v Barclays*
  - No general concept of a duty in English law
  - Law may impose a duty in particular relationships (insurance, duties of directors)
  - IFE suggested implied representation of good faith but in reality issue one of dishonesty
Mismanagement
Timely Provision of Accurate Information

• Is there a duty to provide timely and accurate information?
  • Implied duty
  • Duty to use reasonable care and skill
  • See FSA’s principles of business (Principle 7)
Is The Written Contract The Entire Contract?

- Implied Terms: circumstances
- Parties’ intentions- “necessary to give business efficacy/officious bystander”?
  - debate re whether separate test or both elements required
  - some authors consider that necessity is the practical test for showing the intention of the parties
  - implied term must not contradict the express wording of the contract
- Courts are generally reluctant to imply terms into negotiated contracts
Is The Written Contract The Entire Contract?

- By statute – eg re sale/supply of goods and services
- Custom/usage – rare (legal/certain/reasonable/universally acknowledged/not contrary to express terms)
  - “You should not have purchased collateral outside of the eligibility criteria – collateral should have been fit for purpose”
  - “You ought to have provided me with timely/accurate customer reporting information”
  - “You ought to have managed the investments conservatively”
  - “You ought not to have substituted inappropriate investments”
Is The Written Contract The Entire Contract?

• Collateral warranty/agreement
  • What is it?
  • Usually viewed with suspicion when sophisticated parties involved (Heilbut, Symons & Co. v. Buckleton)
  • Would main contract have been made without it - often indication of intention? (City & Westminster Properties Ltd. v. Mudd)
• NB. Effect of entire agreement clause
Termination

- Is there a contractual right?
- Ambiguity in termination/liquidation provisions
- If no contractual right, investors/others may invoke common law rights to rescind the contract for breach (see eg, BPI case – Exhibit 2)
- Rescission may be *ab initio* in a fraudulent scenario
How Much is the Loss and Damage?

- Valuation difficulties
  - Often difficult to assess loss
  - Different methodologies for valuing CDO’s and CDO assets

- Market quotation and loss
  - ISDA Master Agreement
  - Which formula chosen by the parties?
  - Does the chosen formula produce a commercially reasonable result?
  - How do you bullet-proof” a CDS valuation

- UK: Peregrine case
- US: High Yield Fund; AEP v. BMO
How Much is the Loss and Damage?

- Penalty clauses
  - May be relevant where amounts payable following a breach of contract
  - Liquidated damages/penalty
  - Is the stipulated sum a genuine estimate of loss flowing from the breach? (Dunlop Pneumatic Tyre Company v. New Garage and Motor Company Limited)

- Exclusions/limitation of liability clauses
  - Reasonableness requirement if excluding for misrepresentation or negligence
  - cp IFE case where Judge contrasted a clause which clarified the scope of the representations to an exclusion clause
How Much is the Loss and Damage?

- UCTA 1977 s. 2(2) – but NB paragraph (1) of Schedule 1
- Misrepresentation Act 1967 Section 3
- Mitigation
  - Claimant cannot recover damages for a breach where loss could have been avoided by taking reasonable steps
CDO Class Actions?

- Presumption of reliance based on “fraud on the market theory” not available to CDO investor class.
- Is there another basis for a presumption of reliance?
  - *Affiliated Ute Citizens of Utah v. United States* (U.S. Sup. Ct.)
    - Presume reliance in “omissions” cases
  - *Cromer Finance v. Berger* (S.D.N.Y.)
    - Hedge fund = no public trading = no fraud on the market theory
    - Numerosity requirement barely met (≤100 class members).
    - But class certified because fraud concerned NAV and the Court presumed that every investor relied on NAV.
- *But see Primavera v. Askin* (S.D.N.Y) (denying certification to purported class of hedge fund investors)
- Compare UK Group Litigation Orders
Tips/Final Thoughts

• Audit of real world practices:
  • Detailed assessment of current exposure
  • Examination of documents and sales practices
  • Understanding of regulatory risk in off-shore transactions

• Restructuring:
  • A trap for the unwary but an opportunity for others
  • Obtain a release for prior actions as part of the modification.
  • Improve on existing forum selection provisions
  • Insert jury trial waivers (US)
  • Provide for indemnification

• Plan for dealing with liquidation, collateral call and other events
  • Develop/review procedures for liquidation
  • Have on-call experts to vet valuation and process
  • Conduct the liquidation/calls with anticipation of litigation
Tips/Final Thoughts

- Can drafting errors or mismatches between contractual documentation be exploited?
- Can you take advantage of specific rules governing particular types of contracts, e.g. contracts of insurance/contracts of guarantee?
- Indemnity available under transaction documents
  - Administrative agents; portfolio managers
  - Priority of payments for swap counterparty
- Sharing legal documents between group companies
- Choice of Forum
  - Exclusive –v- non-exclusive
  - Consistency of forum choice in transaction documents
  - Possibility of legal action in a different forum
  - Anti-suit injunctions
  - Tactical considerations
Exhibit 1 –
U.S. CDO Litigation Case Studies
and Regulatory Landscape
Exhibit 1

• A review of U.S. CDO Litigation:
  
  • Bank of New York Trust Co. v. Franklin Advisers, Inc., et al. (S.D.N.Y.)
  
  • SNS Bank, N.V. v. Citibank, N.A. et al. (N.Y. Sup. Ct.) (1st Dep’t)
  
  • Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A. (S.D.N.Y.) (2d Cir.)
  
  • Daniel Boone School Dist. V. Lehman Bros. Inc. (W.D. Pa.)
  
  • Debussy, L.L.C. et al. v. Deutsche Bank, A.G. et al. (S.D.N.Y.) (2d Cir.)
  
  • Deutsche Bank Trust Co. Americas v. Lacrosse Financial Products, LLC, et al. (N.Y. Sup. Ct.)
  
  • Wells Fargo Bank, N.A. v. Calyon, Magnetar Constellation Master Fund, Ltd., et al. (S.D.N.Y.)
  
  • HSH Nordbank AG v. UBS AG and UBS Securities LLC (N.Y. Sup. Ct.)
Exhibit 1

  - BONY was Trustee under an Indenture pursuant to which two Franklin companies issued various classes of notes and securities.
  - Another Franklin company agreed to act as Manager of the collateral provided as security for the debt obligations issued under the Indenture.
  - Certain of the collateral was liquidated pursuant to a Notice of Redemption and the Trustee was charged with making payments from the liquidated proceeds in accordance with the Indenture.
  - BONY, an interpleader plaintiff, alleged that as Trustee it has received competing claims from the Majority Preferred Shareholders and the Collateral Manager and thus was exposed to multiple liability with respect to its disposition of certain funds absent Court resolution.
  - BONY sought to extricate itself by depositing the funds into the Court registry through the interpleader complaint.
Exhibit 1

- **SNS Bank, N.V. v. Citibank, N.A., et al.** (N.Y. Sup. Ct.) (1st Dep’t)
  - Dutch Bank purchased $15MM in income notes in CDO.
  - Bank executed a subscription agreement.
  - The CDO was launched in 1996.
  - In 2000-01, there were significant portfolio losses.
  - In 2001, the Administrative Agent replaced the Portfolio Manager with an affiliate.
  - Portfolio losses continued to mount.
  - Bank’s claims included: breach of contract, breach of fiduciary duty, unjust enrichment.
  - Defendants: Fund, Fund Directors and Officers, Administrative Agent, Portfolio Manager, and Employees of Administrative Agent.
Exhibit 1

• SNS Bank, N.V. v. Citibank, N.A., et al. (cont’d)
  • Motion to dismiss granted; affirmed on appeal.
  • Principal holdings:
    – Income Note holders have no third-party beneficiary standing to assert breaches of Administration Agreement and Portfolio Management Agreement.
    – None of the defendants owed a fiduciary duty to Income Note holders, notwithstanding stray references to “fiduciary” role in marketing and other materials.
    – Defendants were not unjustly enriched where they received fees pursuant to the express formula set forth in the transaction documents and Offering Memorandum.
    – Limitation of liability provisions in Administration and Portfolio Management Agreement were enforceable.
Exhibit 1

• SNS Bank, N.V. v. Citibank, N.A., et al. (cont’d)

Captiva Finance Ltd.

Portfolio Collateral
(Corporate loans and bonds issued by U.S. and Canadian corporations)

$300 Million

$255 Million
Secured Class A Notes

$45 Million
Subordinated Income Notes

SNS Bank ($15 Million)
Other Institutional Investors

United States

Non-U.S. Institutional Investors

Citibank

John Carter
Glenn McLelland
John T. Schmidt

Graham Lockington
Derrie Boggess
Elizabeth Kearns
Darren Riley
David Egglishaw
John Cullinane
Andrew R. Collins
Jennifer Gilbert
David Dyer
Michael Austin
Paul Cope

Chancellor
Stanfield
Citibank

(6/96-12/98)
(1/99 - 7/99)
(8/99 - Present)

Citibank

John Carter
Glenn McLelland
John T. Schmidt

United States

Citibank

Chancellor
Stanfield
Citibank

(6/96-12/98)
(1/99 - 7/99)
(8/99 - Present)

$255 Million
Secured Class A Notes

$45 Million
Subordinated Income Notes

SNS Bank ($15 Million)
Other Institutional Investors

United States

Non-U.S. Institutional Investors
Exhibit 1

  - A historical perspective on default rates
  - Market forces cause of defaults. Would court today be receptive to argument?
• *SNS Bank, N.V. v. Citibank, N.A., et al.* (cont’d)
  • The priority of distribution provision, simplified
Exhibit 1

- *Banco Espírito Santo de Investimento, S.A. v. Citibank, N.A. (S.D.N.Y.) (2d Cir.)*
  - Portuguese Bank purchased $25MM in Income Notes issued by two CDOs.
  - Bank executed a subscription agreement for only one of the two purchases.
  - There were extensive face-to-face meetings prior to each investment at which certain oral representations are alleged to have been made.
  - Bank claimed that defendant promised “active” oversight and management and “protection of principal.”
  - When the portfolio performance deteriorated, there were further written and oral communications.
  - Bank claimed that defendant stated “the portfolio was distressed from the very start” and loans were issued “under lax underwriting standards.”
  - Bank alleged breach of oral promises, fraud on the inducement, breach of fiduciary duty and unjust enrichment.
  - Defendant: placement agent = administrative agent = portfolio manager for one of the two CDOs.
• **Banco Espirito Santo de Investimento, S.A. v. Citibank, N.A. (S.D.N.Y.) (2d Cir.)**
  • Motion to dismiss granted; affirmed on appeal by the Second Circuit.
  • Principal holdings:
    – Disclaimers of reliance in marketing materials and Offering Memorandum effectively disclaimed Bank’s reliance on any extraneous representations, including “oral promises.”
    – “Every promise is a representation.”
    – Ban lacked third-party beneficiary standing to enforce Administration and Financial Management Agreements.
    – The limitation of liability provisions in those Agreements applied.
    – The fraud claim was dismissed because the Bank failed to allege that the defendant knew of the distressed portfolio at the relevant time.
    – The Court *sua sponte* foreclosed any opportunity to amend.
Exhibit 1

Daniel Boone School Dist. V. Lehman Bros. Inc. (W.D. Pa.)

- Pennsylvania school district suffered investment losses in certain unauthorized CMO investments made by its investment advisor.
- Investment advisor had purchased CMOs from Lehman. PA statute prohibited school districts from purchasing such derivative investments.
- School district alleged that Lehman had raised questions about the impropriety of derivatives investments for the school district.
- School district alleged various claims of direct and accessorial liability.
- On motion to dismiss, court dismissed all claims of direct liability and accessorial liability, but let stand a claim for civil conspiracy under PA Law.
- Although Lehman was not primarily liable, it “might be liable as a co-conspirator with [investment advisor] because it sold derivatives to him knowing that his purchase of those derivatives was unlawful.”
Exhibit 1

  - Synthetic CDO investment made in 1998.
  - Plaintiff purchased 100% of the subordinated floating Certificates.
  - Two Scudder mutual funds purchased 100% of senior Notes.
  - A Scudder entity was the original portfolio manager.
  - In April 2002, Deutsche Bank acquired Scudder.
  - Deutsche Asset Management replaced Scudder as Portfolio Manager.
  - Plaintiff approved replacement.
  - Two months later, the Notes were redeemed: 50% recovery of principal.
  - Certificate holder received no return of principal.
  - Plaintiff claims breach of fiduciary duty and breach of contract.
  - District Court: Case dismissed; failure to bring as derivative claim.
  - Affirmed on appeal.
Exhibit 1

• Deutsche Bank Trust Co. Americas v. Lacrosse Financial Products, LLC, et al. (N.Y. Sup. Ct.)
  • Deutsche Bank, as trustee of the Sagittarius CDO, filed an interpleader action in December 2007 to determine whether the CDO's investors (led in this case by UBS) or the CDO's credit insurer (a unit of MBIA that entered into a credit default swap) have the right to the remaining payments under the CDO.
  • The interpleader complaint names as defendants "Does 1 though 100, the owners of the beneficial interests" - that is the investors who bought the interests in the CDOs.
  • The MBIA unit claims it has senior rights as a result of provisions in the credit default swap agreement, a position that unnamed investors have, according to the complaint, characterized as "neither reasonable nor correct." The interpleader action seeks to sort out the competing interests.
Exhibit 1

- **HSH Nordbank AG v. UBS AG and UBS Securities LLC** (N.Y. Sup. Ct.)
  - On February 25, 2008, German state-owned bank HSH Nordbank AG sued UBS and UBS Securities LLC.
  - The lawsuit relates to one of HSH’s constituent bank’s $500 million investment in 2002 in CDO securities created and managed by UBS.
  - HSH also provided UBS with CDS protection.
  - HSH claims that UBS selected inferior collateral and used the CDO as a dumping ground for troubled mortgage-backed securities as a way to profit from the CDS.
  - HSH accuses UBS of breach of contract, fraud, negligent misrepresentation, and breach of fiduciary duty.
  - HSH is demanding at least $275 million in restitution plus punitive damages.
Exhibit 1

- *HSH Nordbank AG v. UBS AG and UBS Securities LLC* (N.Y. Sup. Ct.) (cont’d)
  - Forum: New York state court lawsuit between two foreign-domiciled companies. UBS has counter-sued in the UK.
  - Theory: not a mere misrepresentation or mis-selling claim. Rather, suit looks behind the documents at UBS’s conduct and claims that UBS fraudulently manipulated the transaction structure to its own profit and to the investors’ detriment.
  - Novelty: Apparently the first reported filing of a CDS dispute concerning “sub-prime” assets.
Exhibit 1

• DERIVATIVES: CLOSE-OUT CALCULATIONS
  • *AEP Energy Services, Inc. et al. v. Bank of Montreal (S.D. OH)*
Exhibit 1

• DERIVATIVES: CLOSE-OUT CALCULATIONS
  • Issue: whether Credit Lyonnais properly valued contracts through the Market Quotation procedure.
  • What does “Market Quotation” mean?

“Market Quotation” means, with respect to one or more Terminated Transactions and a party making the determination, an amount determined on the basis of quotations from Reference Market-makers. Each quotation will be for an amount, if any, that would be paid to such party... or by such party... in consideration of an agreement between such party... and the quoting Reference Market-maker to enter into a transaction (the “Replacement Transaction”) that would have the effect of preserving for such party the economic equivalent of any payment or delivery... by the parties under Section 2(a)(i) in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required after that date.
Exhibit 1

• DERIVATIVES: CLOSE-OUT CALCULATIONS
• High Risk Opportunities HUB Fund Ltd. (cont’d)
  • Parties entered into several non-deliverable forward contracts (NDFs).
  • NDFs were currency contracts based on the exchange rate between the US dollar and the Russian ruble where High Risk was entitled to payment at Termination if the value of the ruble declined and Credit Lyonnais if the value of the ruble increased.
  • ISDA Master Agreement with “Event of Default” and “Early Termination Date” provided for calculation of “Settlement Amount” using “Market Quotation.”
  • Series of events placed High Risk in voluntary liquidation.
  • Credit Lyonnais declared Early Termination of eight outstanding NDFs on grounds that High Risk’s insolvency constituted an Event of Default.
Exhibit 1

• DERIVATIVES: CLOSE-OUT CALCULATIONS
• High Risk Opportunities HUB Fund Ltd. (cont’d)
  • Credit Lyonnais contacted 13 market-makers to obtain valuations.
  • Credit Lyonnais instructing the market-makers in writing to consider the existence of Exchange Risk as a factor in valuing the NDFs.
  • Credit Lyonnais followed up with phone calls to several of the market makers.
  • Credit Lyonnais eventually received 4 quotations upon which it relied.
  • High Risk sued Credit Lyonnais claiming it caused High Risk’s insolvency by failing to post margin payments and that it improperly calculated the Settlement Amounts owed.
Exhibit 1

• DERIVATIVES: CLOSE-OUT CALCULATIONS

• High Risk Opportunities HUB Fund Ltd. (cont’d)
  • High Risk claimed that the market quotations were not obtained in good faith.
  • Held:
    – Section 14 is unambiguous and must be enforced according to the plain meaning of its terms.
    – Market Quotation procedure did not mention Exchange Risk, which was instead described in the individual Confirmations, executed after the Master Agreement.
    – Credit Lyonnais failed to act in good faith because it interfered with the market-makers’ independence in valuing the NDFs.
    – Under the Master Agreement, Loss valuation procedure applies where, as here, adequate Market Quotations were not obtained.
Exhibit 1

• DERIVATIVES: CLOSE-OUT CALCULATIONS
• High Risk Opportunities HUB Fund Ltd. (cont’d)
  • What does “Loss” mean?

“Loss” means, with respect to this Agreement or one or more Terminated Transactions... the Termination Currency Equivalent of an amount that party reasonably determines in good faith to be its total losses and costs (or gain, in which case expressed as a negative number) in connection with this Agreement or that Terminated Transaction or group of Terminated Transactions, as the case may be, including any loss of bargain, cost of funding or, at the election of such party but without duplication, loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position (or any gain resulting from them).... A party may (but need not) determine its Loss by reference to quotations of relevant rates or prices from one or more leading dealers in the relevant markets.”
Exhibit 1

- **DERIVATIVES: CLOSE-OUT CALCULATIONS**
  - Natural Gas Commodity Derivatives Transactions: swaps, options, daily gas
  - Large NYMEX-lookalike swap portfolio: over 50,000 NYMEX contract equivalents; net exposure = 7000 contracts
  - 1992 ISDA Master Agreement with “Additional Termination Event”
  - On Feb. 10, 2003, Moody’s lowered AEP’s credit rating = Additional Termination Event; MTM $50MM in favor of AEP
  - On Mar. 13, 2003, MTM $49MM in favor of AEP
  - On Mar. 14, BMO delivers termination notice, seeks market quotes
  - On Mar 24, BMO delivers Settlement Amount calculation, seeking a payment from AEP of $34MM = swing of over $83MM.
  - Lawsuit in Ohio followed.
Exhibit 1

**DERIVATIVES: CLOSE-OUT CALCULATIONS**

**AEP Energy Services, Inc. et al. (cont’d)**


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<td>$250,000.00</td>
<td>($500,000.00)</td>
<td>($485,000.00)</td>
<td>($500,000.00)</td>
<td>($500,000.00)</td>
</tr>
<tr>
<td>Value of Net Position</td>
<td>$250,000.00</td>
<td>($500,000.00)</td>
<td>($495,000.00)</td>
<td>($500,000.00)</td>
<td>($500,000.00)</td>
</tr>
<tr>
<td><strong>Portfolio III</strong></td>
<td>Value of Short Position</td>
<td>-1000</td>
<td>$5,000,000.00</td>
<td>($10,000,000.00)</td>
<td>($7,500,000.00)</td>
</tr>
<tr>
<td>Value of Long Position</td>
<td>950</td>
<td>($4,750,000.00)</td>
<td>$9,500,000.00</td>
<td>$11,875,000.00</td>
<td>$9,500,000.00</td>
</tr>
<tr>
<td>Value of Gross Positions</td>
<td>$250,000.00</td>
<td>($500,000.00)</td>
<td>$4,375,000.00</td>
<td>($500,000.00)</td>
<td>($500,000.00)</td>
</tr>
<tr>
<td>Value of Net Position</td>
<td>$250,000.00</td>
<td>($500,000.00)</td>
<td>($495,000.00)</td>
<td>($500,000.00)</td>
<td>($500,000.00)</td>
</tr>
</tbody>
</table>

Key Assumptions:
- Fixed Price = $4.00/mmBTU
- Bid-Offer Spread for volumes up to 100 contracts = $0.02
- Bid-Offer Spread for volumes of about 1000 contracts = $0.50
Exhibit 2: UK Case Studies
Exhibit 2

- **BPI** was investor in credit linked notes and claimed against Bank of America for:
  - (i) rescission; damages for deceit, misrepresentation, breach of contract, negligent mis-statement, negligent advice and/or other breaches of duty in connection with the sale of credit linked notes;
  - (ii) damages pursuant to an implied term/oral contract made collateral to the sale of such notes between Banco Popolare and Bank of America delimiting the circumstances in which reference entities underlying the notes would be substituted.
- **Similar claim made by Banco Popolare v. Barclays in 2006. Barclays argued fall in the value of CDO’s was result of market conditions.**
- **Both cases settled before trial.**
Exhibit 2

• IFE v. Goldman Sachs International (2007) ALL ER (D) 476 (July)
• IFE explored the nature of the relationship between an arranging bank and a syndicate.
• Case clarifies the extent to which financial institutions who arrange and syndicate credit facilities for clients make implied representations and/or owe duties of care to institutions invited to participate.
• Goldman acted as arranger and underwriter of syndicated debt for Autodis to fund its acquisition of Finelist plc.
• GSI (as arranger) had circulated an information memorandum (IM) to potential investors, including IFE.
• The IM contained an explicit statement (“Important Notice”) that GSI was not making any representation, warranty or undertaking, express or implied, in respect of the information contained in the IM and did not accept responsibility for the accuracy or completeness of the information. This disclaimer is market standard.
• IFE purchased E20m of Autodis bonds from GSI. Some months later, Finelist went into receivership following the discovery of accounting irregularities.
Exhibit 2

- IFE v. Goldman Sachs International (2007) ALL ER (D) 476 (July) (cont’d)

- IFE alleged that GSI had a duty to inform and that by providing to it the IM and due diligence reports on Finelist, GSI had impliedly represented that it was not aware of facts which showed that statements about Finelist’s finances contained in the IM or the DD reports might be materially incorrect.

- CA held that:
  - No duty of care existed sufficient to establish negligent mis-statement
  - GSI was not acting as an adviser and not providing any professional services
  - The relationship as arranger or vendor of the debt was not sufficient to create a duty of care/assumption of liability
  - The disclaimer of liability made it clear that GSI was not assuming liability
  - The only implied representation was of good faith (ie not knowingly putting forward information which was likely to mislead). CA drew distinction between what GSI actually knew and information which might give rise to a possibility that the information was misleading.
  - Because of the express statement that GSI would not check the information in the IM, only if GSI knew that it had information which made the IM misleading could it be liable for breaching the duty of good faith if the necessary dishonest intention was made out.
Exhibit 2

IFE v. Goldman Sachs International (2007) ALL ER (D) 476 (July) (cont’d) Jones Day comment:

• Highlights importance of boilerplate language drafted by specialist lawyers.
• CA - little enthusiasm for imposing a duty of care in negligence on arrangers to disclose information to potential and actual participants in a transaction where the arranger adequately disclaims responsibility.
• Provides comfort to financial institutions who act as arrangers of credit facilities that boilerplate language commonly contained in Information Memoranda will be given due regard if an English Court has to consider what legal obligations they might owe to actual/potential investors.
• In the event of litigation, boilerplate language will be subject to close scrutiny – language should be subject to regular review to ensure protection.
• Those involved in transactions should act consistently with the protection which the arranger seeks from boilerplate language.
• Little benefit to have no representation language included in an IM if those involved in a transaction subsequently make representations to potential participants.
• CA look at the substance of a transaction and not just form.
• If investors wish to get specific assurances from arrangers, they should obtain these expressly.
Exhibit 2

- HSH Nordbank AG V. Barclays Bank Plc 2003 Folio 621
  - HSHN claimed against Barclays for losses it incurred in 2 managed CDO deals (Corvus/Nerva) arranged by Barclays.
  - Claim was for negligence, negligent mis-statement and/or breach of contract
  - Suggestion that Barclays had a wider duty of care to its client and an obligation to act in good faith as opposed merely to observing strict terms of the contract.
  - Case settled on the eve of trial
Exhibit 2

- Peregrine Fixed Income Ltd (In Liquidation) v Robinson Department Store Public Company Limited [2000])
- P provided financial products including SWAP and other derivatives.
- Went into provisional liquidation
- R operated department stores. Financial difficulties itself and had initiated a restructuring.
- P & R entered into SWAP transaction.
- R liable to pay P 25 annual instalments of US$6.85m ending in 2022.
- ISDA Agreement entered into.
- Provisional liquidation was an Event of Default.
- P&R had specified Automatic Early Termination in the ISDA Schedule as applying on an Event of Default.
- P&R had chosen the "Second Method and Market Quotation" formula.
- However largely by reason of Peregrine's own financial position, Market Quotation produced a figure of cUS$9.7m when R's total obligations (after applying discontinuing methods) were US$87.3m (Reference Market-makers are not required or expected to ignore the financial standing of the non-defaulting Party i.e. R).
- Judge found that: Market Quotation measure and the Loss measure are intended to lead to broadly the same result (referring to Australia and New Zealand Banking Group Ltd v Société Général (CA 29 February 2000)).
Exhibit 2

- When assessing damages for the loss of a bargain one does not normally discount its nominal value for the chance that the Obligor will fail to perform – there was nothing in the ISDA definition of Loss to suggest a different approach.
- Market Quotation did not produce a commercially reasonable result.
- R, as the non-defaulting party, was responsible for determining the Settlement Amount and the Agreement provided for the use of the Loss measure only if Market Quotation would not, in the reasonable belief of that party, produce a commercially reasonable result. (See definition of Settlement Amount in s6).
- The Court was not therefore entitled simply to substitute its own judgment of what was commercially reasonable.
- When assessing whether R had acted reasonably, the Court should adopt the approach in Associated Provincial Picture Houses Ltd v Wednesbury Corp [1948] 1 KB 223.
- It was therefore necessary to show that R's decision to use Market Quotation was flawed (in the Wednesbury sense) because matters that ought to have been taken account of were disregarded or they disregarded matters which ought to have been taken account of.
- R's belief was not one which a reasonable person in its position, properly directing himself, in accordance with the Agreement, could hold.
- By adopting Market Quotation instead of Loss R breached the Agreement.
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