

Liability of Swaps Dealers against Users

IOANNIS KOKKORIS*

LT [Keywords to follow]

Introduction

Derivatives transactions drive companies today to efficiencies and sophistication unimaginable only two or three decades ago. To protect against risks associated with particular equities, sovereign debt or bonds, dealers have devised bilateral derivative instruments that allow credit exposures to be transferred. Such bilateral instruments are called swaps and entail an exchange of obligations, which provides a method of risk management. Swaps grew as an instrument to replace parallel loans and back-to-back loans used before the enactment of exchange control legislation.¹

Swaps are developed in the over-the-counter ("OTC") or off-the-exchange markets as unregulated transactions between parties having an arm's length relationship. OTC-derivatives markets are non-centralised markets that comprise myriad privately negotiated transactions. Swaps are individually negotiated, based on notional amounts with payments based on movements in interest, currency, equity or commodity indices. Based on the index we have different kinds of swaps.²

* Ph.D. candidate in Competition Law (King's College London), and Case Officer at the Office of Fair Trading. B.A. (Ecofn.), M.Phil. Cantab, LL.M. The views expressed in this submission are those of the author. The author's email is: ioanniskokkoris@hotmail.com.

1. Exchange control legislation was enacted in the United Kingdom in 1979. Arnel Cates, "Swap Financing", 1986 Symposium: Current Issues of International Financial Law, Part II (1986) 20 *International Lawyer* 837-845 at p.837.

2. For a definition of the main kinds of swaps see the Appendix to this article. See also FN. M. Feder, "Deconstructing Over-the-Counter Derivatives" [2002] *Columbia Business Law Review* 677-748 at p.704.

In this article the author will attempt to investigate the extent of the dealer's liability arising from transactions in swaps. Initially, the article will look at the different types of legal claims that can arise out of such transactions as well as the factors leading to such claims. Subsequently, the article focuses on their contributing factors as well as means to mitigate such claims and looks into specific cases illustrating the implications of such claims.

Enforceability claims

Litigation has commenced in a number of contexts in both the United States and England relating to derivative products provided by financial institutions both to corporate clients³ and to public authorities.⁴ Such claims can be brought by the buyer of a derivative product against the financial institution which sold the product. The complaints in these litigations are based on a combination of common law and statutory rights and can be categorised as ultra vires claims, fraud claims, and suitability claims.

Ultra vires claims

The determination of a company's capacity to enter into contractual obligations was historically dominated by the ultra vires doctrine.⁵ The ultra vires doctrine⁶ can be deployed in three notions in public law.⁷ First, it refers to the situation

3. In cases such as: *Procter and Gamble v Bankers Trust Company* (CV No.C-1-94-735 SD Ohio); *Gibson Greetings v Bankers Trust Company* (CV No.C-1-94-620 SD Ohio); *Adimitra (PT) Rayapratama (AR) v Bankers Co and BTI* (US District Court for the Southern District of New York) August 16, 1995; and *Bankers Trust International v PT Dharmala Sakti Sejahtera* Q.B. Div.'1 Comm. Ct. 1994 Folio Nos.2168 and 1396 (1995). These cases will be analysed in the following parts of this article.

4. *Orange County Investment Pool v Merrill Lynch & Co*, Ch.9 Case No.SA 94-22272-JR, Adv. No.SA 94-1045-JR (C.D.B.R. Cal., filed January 12, 1995). This case will also be analysed in the following parts of this article.

5. Ultra vires is a Latin expression for acts that are beyond (ultra) the legal powers (vires) of the actors. The doctrine imposed artificial limitations on the acts and things which a company was regarded in law capable of doing.

6. The reforms made by the Company Act 1989 have deprived the doctrine of its central role. However, it continues to apply to charitable companies (CA 1989 s.111) and to some bodies such as building societies, and remnants of the doctrine survive in CA 1985, ss.35(3) and 322A. See further: L. S. Sealy, *Cases and Materials in Company Law* (7th edn, Butterworths, London, 2001), p.144. For a detailed analysis of the reforms to the ultra vires doctrine see P. Davies, *Gower and Davies' Principles of Modern Company Law* (7th edn, Sweet and Maxwell, London, 2003), pp.135-142.

7. FN. Bamforth, "Public Law", in P. Birks and F. Rose, *Lessons of the Swaps Litigation* (Mansfield Press, London, 2000), p.48.

where the actor has no capacity to perform the act. Under this notion, it applies to incorporated bodies and thus neither to partnerships nor to chartered corporations, as the *Sutton Hospital*⁸ case indicated. Secondly, it can be a consequence of a court finding according to which a decision-maker's action must be set aside as unlawful, since the actor has exceeded his authority in performing a particular action. Finally, the notion of ultra vires can also apply to any activity which the company cannot lawfully undertake.⁹

According to the ultra vires doctrine, in addition to the company's natural limitations on its capacity, it was incapable of doing anything not included in its objects clause,¹⁰ as was indicated by the *Ashbury*¹¹ case. This restrictive nature of the ultra vires doctrine after *Ashbury* was weakened after *Re David Payne & Co Ltd*,¹² where the issue was whether power use was ultra vires to the issue of corporate capacity.¹³ In addition, according to *Re Jon Beauforte*,¹⁴ persons dealing with a registered company should have notice of its "public documents", and thus of the contents of its "object clause". Finally, in *Bell Houses*¹⁵ the scope of the companies' object clause was further widened by the company determining its limits of the objects clause.

Although the literature and case law concerning the ultra vires doctrine is vast, this article will focus on the applicability of the ultra vires doctrine for transactions involving swaps. In *Hazel*¹⁶ many swaps entered into by local authorities were deemed ultra vires and therefore void. The term ultra vires was thus given a third narrower meaning as a label for the consequence where a public authority acted outside its statutory powers.¹⁷

8. (1612) 10 Co. Rep. 1a 23a.

9. Davies, fn.6 above, at p.131.

10. Sealy, fn.6 above, at p.144.

11. *Ashbury Railway Carriage and Iron Co v Riche* (1875) L.R. 7 HL 653.

12. [1904] 2 Ch. 608.

13. i.e. whether the power in question was capable of being used to pursue the corporate objects. See further: S.Griffin, *Company Law, Fundamental Principles* (2nd edn, Pitman, London, 1996), p.95.

14. *Re Jon Beauforte* [1953] Ch. 131.

15. *Bell Houses Ltd v City Wall Properties* [1966] 2 Q.B. 656.

16. *Hazel v Hammersmith and Fulham LBC* [1992] 2 A.C. 1.

17. In that sense, a corporation was prohibited by law from engaging in a particular transaction as was the case in *Orange County Investment Pool v Merrill Lynch & Co*, according to which, the transactions Orange County engaged in with Merrill Lynch were prohibited by the California Constitution since Orange County had to borrow in excess of its income and revenue for that year. Similarly in *Lehman Bros Commercial Corp v China International United Petroleum and Chemicals Co Ltd (UNIPEC)* foreign exchange swaps were illegal according to Chinese laws. *Orange County Investment Pool v Merrill Lynch & Co*, fn.4 above. *Lehman Bros Commercial Corp v China International United Petroleum and Chemicals*

In England the powers a local authority has in executing its functions are stipulated in s.111(1) of the Local Government Act of 1972.¹⁸ In relation to the issue whether swaps facilitate or are conducive or incidental to local authorities' functions as s.111(1) requires, Lord Templeman argued that such transactions do not facilitate and are neither conducive nor incidental to the borrowing function. As Lord Woolf stated in *Westdeutsche*,¹⁹ the decision in *Hazel*²⁰ had caused dismay among some of those concerned with the standing abroad of the commercial law in England. Furthermore, as Mr Justice Hirst stated in *Re Interest Rate Swap Litigation*²¹:

"this is an application in the Interest Rate Swap Litigation, which comprises a very large number of civil actions between banks and local authorities following upon the decision in the House of Lords in *Hazel*, that such transactions were *ultra vires* and unlawful."

These statements indicate the important economic and political consequences of ultra vires claims.²²

In the development of the ultra vires doctrine courts failed to draw a clear distinction between the notion of ultra vires as indicating lack of company's capacity and illegality or lack of authority of the company's officers or agents.²³ Thus, similar to ultra vires claims are contract claims that refer to situations where an investor can claim that he is not bound by the swap transaction owing to his incapacity to enter into such transactions. In such circumstances the transaction is void *ab initio*.²⁴

In addition, following *Freeman and Lockyer v Buckhurst Properties*,²⁵ in order for a contracting party to be able to raise a valid claim of ostensible authority against the company it must be shown that a representation that the agent had authority to enter into the contract was made to the

Co Ltd (UNIPEC), No.94-CIV-8304 (S.D.FN.Y., filed November 15, 1994).

18. Sch.13 to the 1972 Act, which limits the local authority's borrowing power, cannot be interpreted as allowing for any incidental power to enter in swap transactions. Bamforth, fn.7 above, at p.51.

19. *Westdeutsche Landesbank Girozentrale v Islington BC* [1994] 4 All E.R. 957, CA; [1996] A.C. 669, HL.

20. *Hazel v Hammersmith and Fulham LBC* [1991] 2 W.L.R. 372.

21. Judgment of November 28, 2001. See further www.ucc.ie/law/restitution/archive/englcases/interest.htm.

22. It could be argued that ultra vires claims are commonly invoked when the swap has not been profitable, so as to mitigate the ensuing losses. Therefore in the United States courts are reluctant to apply the doctrine, while corporate charters are made in broad terms so as to avoid such claims.

23. Davies, fn.6 above, at p.133.

24. Illustrative cases include the *Hazel* and *UNIPEC*, where similar to the ultra vires claim, the argument is that the agent had no corporate authority.

25. [1964] 2 Q.B. 480. See further S. Goulding, *Company Law* (2nd edn, Cavendish Publishing, London, 1999), p.167.

contractor, such representation was made by a person or persons who had the “actual” authority to manage business of the company, the contractor relied in the representation to enter into the contract and finally that the company had the capacity to enter into the contract.²⁶

There is the possibility that a person has implied authority owing to him being vested with the authority of a person appointed to a particular position.²⁷ In *Hely-Hutchinson v Brayhead Ltd*,²⁸ the ostensible authority of the agent, expressly delegated to him, overlapped with his implied authority arising from no express delegation of authority to him but owing to him being in a particular position. At first instance the case was decided on ostensible authority, while on appeal it was decided on implied actual authority.

Fraud claims

Derivative transactions are subject to common law or to statutory law such as, in the United States, the Securities Act 1933 and the Securities Exchange Act 1934 (“1934 Act”), the regulatory body for which is the Securities and Exchange Commission (“SEC”), as well as the Commodity Exchange Act (“CEA”) the regulatory body for which is the Commodity Futures Trading Commission (“CFTC”). Swaps are not determined as being either securities or commodities.²⁹ The definition of securities in the 1934 Act is quite broad. Swaps transactions have generally been unregulated except if they are conducted by a regulated entity or if the utilisation of a particular index or a particular form of transaction results in them falling within the securities or futures categories, as a matter of law, which are regulated in the United States by the CEA.³⁰ Hence financial institutions have an incentive to attempt to

fit swaps transactions under the CEA or the Securities Acts and thus engage in fraudulent actions. The above-mentioned inclusion of swaps within the securities or futures categories can be illustrated in the *Gibson Greetings* case where SEC and CFTC charged Bankers Trust with fraud in the sale of certain swaps transactions falling within the securities category.

A difficulty entailed in, and to an extent inducing, fraud claims, including derivatives falling within the securities category, is the extent of information regarding the transaction that the dealer must disclose.³¹ OTC derivatives are tailored for specific investors and thus disclosure needs must be judged in the context of these particular investors.³²

Suitability claims

The aforementioned issue regarding disclosure of relevant information is closely connected with the suitability of a seller’s product recommendations and discretionary transactions. Suitability claims appear as pure suitability claims and as disclosure suitability claims. The first type of claims corresponds to cases where the financial institution violates its obligations to recommend and sell only suitable investments (failure of seller to deal with integrity and fairness). The burden of proof lies with the buyer who must prove the unsuitability of the investment, the seller’s duty not to recommend unsuitable investments, the intent in the seller’s actions and his reliance on the seller’s advice. An unacceptable amount of risk entailed in a transaction should be considered to be a breach of duty owed to the client.³³

Buyers can base their claims on the common law of fiduciary duty, on r.10b-5 of the 1934 Act,³⁴ on the National Association of Securities

26. In addition, an investor can also claim that there is no contract owing to prior oral arrangements which are not included in the contract. Such claims were evident in both the *P&G* and the *UNIPEC* litigations analysed below. The Unfair Contract Terms Act 1977 (“UCTA”) and the Unfair Terms in Consumer Contracts Regulations 1994 in England have incorporated sections dealing with the inability of sellers to restrict their liability to written agreements; s.2(2) of UCTA. The Companies Act 1989 (ss.35(1), 35A(1), 35A(2)), has eliminated much of the problem that a contract for a transaction which is not within the powers of the company is unenforceable against the company.

27. Goulding, fn.25 above, at p.169.

28. [1968] 1 Q.B. 549.

29. G. Schinasi, R. S. Craig, B. Drees and C. Kramer, “Modern Banking and OTC Derivatives Markets—The Transformation of Global Finance and its Implications for Systemic Risk” (IMF, Occasional Paper 203, 2000), p.34.

30. S. Henderson, “Derivatives Litigation in the United States”, in *Swaps and Off-Exchange Derivatives Trading: Law and Regulation* (E. Bettelheim H. Parry and W. Rees ed., Financial Times Law and Tax, London, 1996), p.215.

31. This article will deal with disclosure standards at a later stage.

32. It has been argued that swaps are generally not considered securities. See further F. Puleo, “Derivatives: A Banker’s Primer” (1996) 113(8) *Banking Law Journal* 768–783 at p.770.

33. A. Hudson, *The Law on Financial Derivatives* (2nd edn, Sweet & Maxwell, London, 1998), p.199.

34. r.10b-5—“Employment of Manipulative and Deceptive Devices: It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,

a. To employ any device, scheme, or artifice to defraud,
b. To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or

c. To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person,
in connection with the purchase or sale of any security.”
www.law.uc.edu/CCL/34ActRls/rule10b-5.html.

Dealers' ("NASD") Suitability Rule and on the New York Stock Exchange Know Your Customer Rule. A buyer could argue, under r.10b-5, that a seller has engaged in fraud by selling unsuitable investments. In this respect, it could also be argued that a sophisticated investor, being able to know for himself the suitability of his investments, should not have a suitability claim against a seller. The acceptance of a risky bet may indicate approval of its suitability for his investment purposes. However, a buyer's sophistication does not determine the suitability of an investment. Moreover, the relationship between a banker and a customer does not necessarily give rise to a fiduciary duty.³⁵ In the *P&G* case, analysed below, Bankers Trust was allegedly sold a product without recognising its unsuitability.

The disclosure suitability claims comprise pure suitability claims and fraud claims. According to these claims, the seller is liable for not disclosing the unsuitability of the investment (e.g. material risk) to the buyer who relies on the seller's advice. The seller must not exert undue influence over the buyer by selling him unsuitable products. A claim for undue influence, if successful, permits the buyer to set aside the transaction, an action categorised as a form of constructive fraud.³⁶

The following section of this article assesses the factors that contribute to enforceability claims and examines ways to mitigate their impact.

Factors conducive to enforceability claims and how to mitigate their impact

The *New York Times* asked the following question: are derivatives a high-tech 1990s version of financial snake oil? Is there anything inherently dangerous about them? The answer is a qualified "no" according to the central bankers, economists, commercial bankers and corporations that use derivatives.³⁷ OTC derivatives are dedicated to risk management, yet themselves generate risks. Such risks contribute to the proliferation of enforceability claims.

Risks associated with OTC derivatives

Credit risk

Credit risk is the risk of default by one of the parties. It entails the risk of deterioration of the

35. *National Westminster Bank v Morgan* [1985] A.C. 686.

36. *Barclays Bank v O'Brien* [1994] 1 A.C. 180.

37. D. Horwitz, "Derivatives: The Basics on Terms and Risks", *Business Law Today*, October 5, 1995, p.38.

counterparty's creditworthiness up to the extent of the counterparty's insolvency, while market-wide credit deterioration may also affect the credit quality of counterparties. A swap's credit risk is difficult to quantify because the future obligations of each party will vary depending on changes in the underlying reference rates. Credit risk can be divided in two categories: counterparty risk and settlement risk.³⁸

Counterparty risk is the risk that the counterparty will become insolvent prior to the settlement of the transaction. The loss of the non-defaulting party is equal to the swap's replacement cost that is the cost of obtaining a replacement swap on the same terms as the one that remains of the defaulted original. Counterparty risk can be mitigated by bilateral counterparty risk control mechanisms such as termination netting and credit support in the form of collateral.³⁹

Settlement risk is the risk that one party will fulfil its part of the scheduled exchange but the counterparty will not reciprocate. It is most acute in currency swaps where owing to time difference or possibly exchange rate control (country risk) one party remits funds to the counterparty before receiving funds from it. Payment netting (settlement netting) can be used to tackle that risk⁴⁰ and includes the set-off of whatever is payable and receivable on any given settlement date.⁴¹

Market risk

Market risk is the risk of adverse movements in market conditions (exchange rates, interest rates, equity prices) which will change the value of the contract. Both parties to a swap are exposed to market risk. It is this sort of risk that swap

38. Feder, fn.2 above, at p.722.

39. Other means include the existence of subordinated debt as a protective cushion, the diversification of the swap geographically and by industry so as to limit exposure to a single counterparty, and the requirement for high credit ratings of the counterparty, although it has been argued that pricing in the swaps market does not materially take counterparty creditworthiness into account. See further H. Scott and P. Wellons, *International Finance: Transactions, Policy and Regulation* (8th edn, Foundation Press, New York, 2001), p.1045. In addition private swap insurance, guarantees and periodically marking the swap contract to market can mitigate counterparty risk. See further B. Darringer, "Swaps, Banks and Capital: An Analysis of Swap Risks and a Critical Assessment of the Basle Accord's Treatment of Swaps" (1995) 16 *University of Pennsylvania Journal of International Business Law* 259, no page references in Westlaw. Mark to market refers to the daily valuation of securities at market prices. For the definition see further Scott and Wellons, *ibid.*, at p.1353.

40. The Basle Committee released a paper in September 2000 entitled "Supervisory Guidance for Managing Settlement Risk in Foreign Exchange Transactions".

41. An escrow agent can also be used, to whom funds will be paid and will release these funds only on receipt of the necessary funds from both parties. See further E. Sunderland, "Derivatives—Risky Business" (2001) 16(2) *Journal of International Banking Law* 58.

transactions are designed to exchange between the parties to the swap. A party will measure the market risk to its overall portfolio.⁴²

Unlike swap credit risk, swap market risk can be hedged completely by creating synthetic swaps through the use of treasury bills, futures and forwards. Moreover, a financial intermediary by entering into mirror swaps can theoretically completely eliminate market risk since a change in the underlying reference rate causing one of the swaps to be out of the money⁴³ will cause the other one to be in the money by an equal and offsetting amount.

Liquidity risk

Liquidity risk is the risk that a party will be unable to transact due to lack of immediately available resources. The Basle Committee on Banking Supervision⁴⁴ has distinguished liquidity risk into market liquidity risk and funding liquidity risk.

The former is the risk that a party will not be able to terminate a swap prior to maturity. OTC contracts are difficult to liquidate since they are not assignable without the counterparty's consent. A way to tackle that risk is the counterparty to consent in the sale of the contract to a third party. Its consent will depend on the creditworthiness of the third party being equal or exceeding the assigning party's creditworthiness.

Funding liquidity risk is the risk that a party called upon to meet its payment obligations is unable to provide the necessary funds. To deal with this risk, parties may use collateral agreements where a party, if exposure exceeds a certain threshold, posts collateral to the counterparty. The collateral will be returned if the market moves favourably to the party that deposited the collateral. Liquidity risks will be further limited owing to the variety of tradable instruments to synthetically hedge and replicate swaps.

Operational risk

Operational risk is the possibility that the internal monitoring, measurement and controlling systems of a party conducive to the management of credit and market risk will prove inadequate owing to human error or management failure. To deal with such a risk, proper internal controls and plans

42. Market risk has been addressed by the Capital Adequacy Directive (Council Directive 93/6) under which banks and investment firms have to retain capital in order to provide for market fluctuations. See *ibid.*, at p.58.

43. An option the exercise of which will not be profitable (opposite to: in the money). See further D. Emery and J. Finnerty, *Corporate Financial Management* (International edn, Prentice Hall, United States, 1997), p.G13.

44. In its paper "Recommendations for Public Disclosure of Trading and Derivatives Activities of Banks and Securities Firms", published in October 1999.

for contingencies or emergencies are needed. The effectiveness of such measures is mitigated though, if they can be evaded as happened in the Barings⁴⁵ débâcle.

Systemic risk

Financial intermediaries dealing with OTC derivatives act as both dealers and end-users and thus are closely interdependent. Systemic risk entails the risk of the whole financial system collapsing owing to an initial failure of one or few players which failure could reverberate to other financial institutions as well. One could say OTC derivatives are ironic, since they aim to manage risk at a micro level but at the same they can increase risk at a macro level. The counter-argument is that OTC derivatives do not cause greater risk than any other financial obligation while they can also be stabilising for the financial system since they allocate risks to parties better able to deal with them.

The ability of financial markets to withstand a major failure is evidenced by the Barings and *Orange County* débâcles. Furthermore, a 1995 central bank survey⁴⁶ indicated that OTC derivatives markets have successfully withstood several episodes of changes in interest rates, price shocks and interest rate cycles.⁴⁷ The survey argues that derivatives decrease rather than increase systemic risk due to their widespread use in hedging. On the contrary, Wall *et al.* argue that a widespread breakdown of financial markets although unlikely is not impossible.⁴⁸

Legal risk

Legal risk is the risk of loss because an OTC derivatives contract cannot be enforced. Generally, the notion entails risks arising from insufficient documentation, insufficient capacity or authority of the counterparty (*ultra vires*), uncertain legality of instruments, unenforceability in bankruptcy or insolvency⁴⁹ and inadequate disclosure of risks involved in swaps transactions.⁵⁰

45. The oldest British merchant bank, Baring Brothers, collapsed over the weekend of February 25–26, 1995. A 28-year old employee based in Singapore, trading futures and options contracts, amassed losses exceeding £860 million with Baring's capital being £540 million. For a detailed analysis of the Barings débâcle see further Scott and Wellons, fn.39 above, at pp.985–1019.

46. J. Kambhu, F. Keane and C. Benadon, "Price Risk Intermediation in the Over-the-Counter Derivatives Markets: Interpretation of a Global Survey" (1996) 2 *Economic Policy Review* (Federal Reserve Bank of New York) 1 at pp.1–16.

47. Scott and Wellons, fn.39 above, at p.1053.

48. L. Wall, E. Tallman and P. Abken, "The Impact of a Dealer's Failure on OTC Derivatives Market Liquidity during Volatile Periods" (Federal Reserve Bank of Atlanta, Working Paper 96-6, 1996). See Scott and Wellons, fn.39 above, at p.1056.

49. See Horwitz, fn.37 above.

50. Moreover, legal risks can also arise as a result of uncertainty of consumer's funds owing to the regulatory

Two major contributory factors to the legal uncertainty characterising OTC derivatives are the lack of adequacy and clarity of OTC regulation⁵¹ and the uncertainty related to disclosure and documentation standards.

OTC regulation

An initial concern is the costs associated with broker-dealer regulation in the United States, which have affected the conduct of the OTC derivatives transactions. For those transactions (swaps) that are not considered to be securities as defined by law, most dealers have established unregulated affiliates within the United States. Such affiliates add to the operational complexity of parents and induce further legal and operational risks. To integrate the activities of such affiliates into official oversight, SEC has established the category of OTC Derivatives Dealers, which includes the "broker-dealer lite"⁵² approach to conducting risk management.

Legal uncertainty in the United States is primarily related to issues such as whether certain swaps are subject to the CEA, whether certain securities-based derivatives fall under the jurisdiction of the SEC or CFTC and whether the executing and clearing mechanisms of OTC derivatives could affect the ones exempted from the CEA. The CFTC Swap Exemption Act,⁵³ in 1993, excludes swap contracts from the CEA. To qualify for the exemption⁵⁴ the parties must be eligible swap participants as defined by the FTPA,⁵⁵ the swap must not have standardised material economic terms, the swap must not be entered into through a "multilateral

delay of governments (as in Barings), improper credit support, differences in bankruptcy laws among countries, limitation of netting arrangements to mitigate risks, taxation issues in cross-border derivatives transactions, close-out netting, in case of insolvency, not being recognised by certain jurisdictions, recharacterisation of certain structures as unintended transactions as well as counterparties being misled by sophisticated market makers.

There could be several lawsuits emanating from such risks. The forum-shopping that plaintiffs can in some cases engage in may lead to even greater costs for the dealers. Parties facing large losses in their contracts could bring suits against swap dealers, pressuring them to settle such claims. The costs and uncertainties entailed in these suits and settlements could severely hinder the further development of the swaps market.

51. As evidenced by the Long-Term Capital Management débâcle. See further www.erisk.com/Learning/CaseStudies/ref_case_ltcn.asp and "Senator Lugar Remarks on the Regulation of Over-the-Counter Derivatives", www.futuresindustry.org/presscen-2169.asp?pr=13.

52. The results of this approach are doubtful since it is based on the firms volunteering to register their affiliates as OTC Derivatives Dealers.

53. r.35 of that Act.

54. M. Sachheim, "Credit Derivatives: Safe Harbors under the CAE", www.lp.findlaw.com.

55. Futures Trading Practices Act of 1992.

transaction execution facility" and counterparty creditworthiness must be a material consideration in entering into the swap.

There were, however, "legal certainty" problems with the interpretation of these criteria. These included the continuous concern that the CFTC may change the Swap Exemption, the changes in the legal and regulatory environment of OTC transactions owing to the high pace of innovation⁵⁶ as well as ambiguities and potential overlaps of CFTC and SEC jurisdictions.⁵⁷ Section 103⁵⁸ of the Commodity Futures Modernization Act ("CFMA")⁵⁹ provided two routes for exclusion of swaps from CEA jurisdiction. The desire, though, to limit the parties that can participate in OTC derivatives transactions created new uncertainty problems as to whether a given OTC transaction is excluded from the CEA.

A preferable approach⁶⁰ for the reduction of legal uncertainty would be to exclude from the CEA all financial derivatives, except those based on agricultural products, unless a trading facility for such transactions has specifically requested to be covered and regulated under the CEA. This approach would give the investors the option to become subject to the CEA if they thought that the regulations therein would be to their benefit.⁶¹

Disclosure and documentation standards

The second contributory factor to the legal uncertainty is the uncertainty related to disclosure and documentation standards. The different disclosure standards for swaps include accounting rules, information of financial reporting and last but not least information to market participants or regulators. Regarding disclosure of accounting rules, FASB⁶² in 1997 produced an amendment to the new draft statement⁶³ of the 1996 "Accounting for Derivatives and Similar Financial Instruments

56. e.g. the rise in electronic trading reduced the clarity between bilateral and multilateral trading and the increase in the importance of central clearing systems.

57. Specified the authority of CFTC and SEC on the various financial instruments. The Shad-Johnson Accord 1983 aimed at dealing with the overlap of CFTC and SEC, but resulted in further uncertainty regarding the status of swap agreements that were referred as "non-exempt securities".

58. "Legal Certainty for Excluded Derivatives Transactions".

59. December 21, 2000.

60. Scott and Wellons, fn.39 above, at p.1062.

61. Another method is the removal of the legal obstacles to a clearing house for OTC derivatives, which would increase confidence in the market and reduce systemic risk. See further M. Jickling, "Derivatives Regulation: Legislation in the 106th Congress", October 10, 2000 www.ncseonline.org/NLE/CRSreports/Economics/econ-82.cfm?CFID=6810955&CFTOKEN=23277362.

62. Financial Accounting Standard Board.

63. Statement of Financial Accounting Standards No.13X, Accounting for Derivatives Instruments and for Hedging Activities.

and for Hedging Activities",⁶⁴ including certain changes from the 1996 Draft regarding the gain or loss on a hedged asset or on a liability attributable to the risk being hedged.⁶⁵ The amendment was opposed by the financial industry and after the issue was brought to the Congress, the setting of standards in accounting was shifted from FASB to the SEC.

SFAS⁶⁶ has produced accounting standards regarding the voluntary disclosure of quantitative information of interest rate risk and other market risks that are relevant to the management of such risks. Regarding market reporting, the Bank for International Settlements ("BIS") has produced the Fisher Report recommending that financial intermediaries should publicly disclose periodic quantitative information on the management's estimates of market and counterparty risks.⁶⁷

Disclosure standards have been set by the International Swaps and Derivatives Association ("ISDA"),⁶⁸ according to which disclosure is voluntary and actionable only when it is inaccurate or intentionally misleading. ISDA has adopted an approach similar to common law according to which liability based on misrepresentation will be available to buyers upon proof, the burden of which lies on the buyer, that the buyer was expected to rely on the representation.⁶⁹

Many of the enforceability claims and risks already discussed are related to the negotiations between the parties entering into the swap transaction. Each agreement lays out the particular terms of each transaction. Such documentation in derivatives contracts differs among jurisdictions and products. Terms regarding termination and settlement calculation are important in the drafting of a legally sound contract.

ISDA has, since 1980s, been involved in the standardisation of documentation for OTC derivatives transactions.⁷⁰ ISDA has recently issued the 2002 Forms of Master Agreement updating the 1992 ones as well as adding new provisions.⁷¹ These forms are used to document transactions between parties in different jurisdictions and/or transactions involving different currencies. ISDA has also circulated four protocols⁷² allowing for amendments to a party's pending transactions under ISDA Master Agreements.⁷³

Standardisation of documentation has also limits including the difficult standardised language, its continuous evolution alongside that of the derivatives products and markets as well as the compromises that have to be made as a result of parties operating according to their unique aims and under their respective legal regimes. These

64. The "Accounting for Derivatives and Similar Financial Instruments and for Hedging Activities" left the issue of the definition of "hedge" unresolved.

65. Only a portion of this gain or loss is eligible for accelerated earnings recognition and all the gain or loss on the hedged item can be recognised in current earnings even if it is not fully offset by the gain or loss on the hedging item. See further Scott and Wellons, fn.39 above, at p.1065.

66. Statement of Financial Accounting Standard ("SFAS") 119, Disclosure about Derivative Financial Instruments and Fair Value of Financial Instruments, October 1994. Further details can be found in H. Scott, "Liability of Derivatives Dealers", in *The Future for the Global Securities Market* (F. Oditah ed., Clarendon Press, Oxford, 1986), p.274.

67. Further details on the Fisher Report can be found in Scott, *ibid.*, at p.275. SEC has also adopted a disclosure rule. That rule limits required disclosure of qualitative information, with respect to information which is less specific to market risk, while regarding quantitative information gives the registrants the option to choose between three alternatives: tabular presentation, sensitivity analysis or value-at-risk, each of which entails different methods of disclosing information regarding fair values of instruments, cash flows of market risk, potential loss in future earnings and other relevant market risk information. Finally, the Basel-IOSCO (International Organisation of Securities Commissioners) report covers similar issues as the SEC but in less detail, with the difference that the report's recommendations are not binding and cover a wider array of risks.

68. In the "Principles and Practices for Wholesale Market Transactions", issued on August 17, 1995.

69. As considered in *Bankers Trust International v PT Dharmala Sakti Sejahtera*. Moreover, as Lord Selborne L.C. stated in *Barnes v Addy*, the core notion for liability is knowledge of a dishonest and fraudulent design. See further *Barnes v Addy* [1874] 9 Ch. App. 244. See further A. Hudson, *The Law on Financial Derivatives*

(2nd edn, Sweet & Maxwell, London, 1998), p.189. The ISDA approach is in contrast to the Security Act 1933 approach according to which disclosure is mandatory and lack of it induces liability for the dealer.

70. Other entities engaged in OTC derivatives standardisation include the British Bankers' Association that published terms and conditions for short-term London Interbank interest rates and currency swaps and dealt with foreign exchange standardization (1992). See further Feder, fn.2 above, at p.740.

71. New provisions include: a new measure of damages provision, Close-out Amount, which replaces Market Quotation and Loss in the 1992 ISDA Master Agreements; a set-off provision in s.6(f); Force Majeure Termination Event in s.5(b)(ii); and consolidated interest and compensation provisions in s.9. Amended provisions include: a shortening of grace periods associated with some of the Events of Default in s.5(a). See further www.isda.org/publications/isdamasteragrmt.html.

In 1992 ISDA published two improved forms of Master Agreement. Each agreement consists of two parts: the first lays out the basic terms of the master and the second is a Schedule on which some of those terms may be completed, supplemented or varied (also includes the "Credit Support Documentation"). Each transaction is connected to the master agreement by entering into a "Confirmation", compared to the 1987 ones Interest Rate Swap Agreement (for rate swaps in US dollars) and the Interest Rate and Currency Exchange Agreement form (for rate and currency swaps in other currencies) which standardised the range of basic terms in various swap transactions and have dominated the OTC derivatives market since. One regarded the international transactions involving more than one currency and the other the domestic transactions involving domestic currency.

72. EMU Protocol (1998), 2001 EMU Protocol (Greece) (2000), 2001 ISDA Credit Support Protocol and 2001 Euro Protocol.

73. It has also published a wide variety of confirmation forms for many types of transactions and other agreements and materials that have played a critical role to the expansion of the derivatives markets.

drawbacks though do not degrade the importance of the standardisation of OTC derivatives transactions as regards the regulation of OTC derivatives and the disclosure and documentation standards. Such standardisation of OTC derivatives will enhance legal certainty.

The following part of this article will review important cases that will illustrate how enforceability claims have been dealt by courts.

Case law

After setting out the market and regulatory contexts we can look into cases as illustrations of the pitfalls related with OTC transactions. Some of the most important cases include *Gibson Greetings, P&G, Dharmala, Adimitra* and *Orange County*.

Gibson Greetings⁷⁴

Gibson had entered into various complex transactions involving swaps with Bankers Trust ("BT"). After unfavourable movements in interest rates, Gibson liabilities increased swiftly and Gibson cancelled the transactions. It also filed suit claiming fraudulent and negligent misrepresentation⁷⁵ as well as breach of the sections of the CEA dealing with commodity trading advisers ("CTA").

BT stressed the arm's length commercial nature of the transactions involving no advisory or fiduciary relationship (as indicated by the ISDA Agreement) since Gibson, being a sophisticated enterprise, had its own financial advisers. It also argued that the specific transactions were Gibson's decision after being informed of the alternative straightforward swaps. BT also counterclaimed for a declaration that the transactions were valid and enforceable with the terms of which Gibson had to comply.

In November 1994 BT and Gibson settled the dispute for a payment of \$6.2 million⁷⁶ from Gibson with no further liability.

The regulatory aftermath of this case involved both CFTC and SEC separately filing and settling proceedings with BT, for violation of the anti-fraud provisions of the CEA relating to CTAs and of the two Securities Acts for material misrepresentation and omissions. BT was required to adopt compliance procedures.

74. *Gibson Greetings v Bankers Trust Company* (CV No.C-1-94-620 SD Ohio).

75. In particular that it was misled by BT as to the risks inherent in the swaps.

76. Gibson's initial claim was for \$23 million in damages from the transactions plus \$50 million in punitive damages.

Procter and Gamble⁷⁷

This case involved swap agreements consisting of a custom-made swap (5/30 swap) in November 1993 and the Deutschmark ("DM") swap in January 1994 based on the stability of the Deutschmark. Before the end of term for these swaps, P&G unwound them since it was making a loss. The dealer, BT (Bankers Trust), claimed the money P&G owed it, but P&G claimed⁷⁸ indebtedness and sued in 1994 for declaratory judgment that BT had violated the Securities Acts (1933 and 1934), the CEA, the Ohio Deceptive Trade Practices Act and the Racketeer Influenced and Corrupt Practices Act ("RICO") by engaging in fraudulent and negligent misrepresentation as well as by breaching its fiduciary duty. P&G further argued that the swaps were void.

BT argued that the ISDA agreement with P&G, which contemplated an arm's length relationship, in addition to the sophistication of P&G, did not establish any advisory or fiduciary obligation, since its advice to P&G was distinct from the transactions with P&G. BT also pointed to other risky transactions P&G had entered. BT further counterclaimed that there is no private right for action under CEA or CFTC and that the swap was valid so P&G had to comply with the terms.

On May 8, 1996, the court argued that swaps do not constitute securities under both the 1933 and 1934 Acts and the swaps in question were not under the CEA as futures contracts since they were excluded under the FTPA. Moreover, it stated that the relationship under the ISDA Agreement is not of fiduciary nature and rejected P&G's claims of negligent misrepresentation. The court also rejected claims under the Ohio Deceptive Trade Practices Act since the ISDA between the parties was governed by New York law.

On May 9, 1996, the two parties settled their dispute with P&G paying \$35 million plus a swap of \$14 million to BT with no further liability.⁷⁹

Dharmala⁸⁰

Dharmala entered in a two-year interest rate swap with BT in January 1994, which cancelled in February 1994 and entered into a second more complex and riskier swap. By May 1994 the second swap had a negative value for Dharmala.

77. *Procter and Gamble v Bankers Trust Company* (CV No.C-1-94-735 SD Ohio).

78. Similar to claims in the *Gibson Greetings* case.

79. P&G's initial claim was for compensatory damages of \$195.5 million plus punitive damages or a declaration that swap was void, plus attorney fees.

80. *Bankers Trust International v PT Dharmala Sakti Sejahtera* Q.B. Div.'1 Comm. Ct. 1994 Folio Nos.2168 and 1396 (1995).

BT initiated proceedings in December 1994 for damages of \$65 million under the ISDA Agreement. Dharmala in order to annul the swap argued that the swaps were unsuitable for its investment purposes and that BT had engaged in misrepresentation and had failed to meet its duty of care. The court (decision of Mance J.) stated, in favour of BT, that no duty of care existed in the commercial context of the transactions, that Dharmala was sophisticated enough to determine its own risks, and further that the alleged misrepresentation issue was not supported by the facts and there was no issue of deceit of any employees of BT.

Adimitra⁸¹

Adimitra had entered into a leveraged swap with BTI, the wholly owned English banking subsidiary of BT, which under the ISDA Agreement was governed by English law. Adimitra instituted proceedings in the United States,⁸² arguing that the ISDA Agreement was irrelevant and that its claim was in tort thus aiming to avail itself of the broader discovery proceedings in the United States.⁸³ Adimitra alleged misrepresentation, failure of BT to meet its duty of care to an unsophisticated user and lack of authority of its officer to enter into the swaps. BT counterclaimed that Adimitra was engaging in forum-shopping and that the appropriate forum was England. The court dismissed Adimitra's claims, emphasising that the choice of law clause in the ISDA Agreements applies to all claims arising out of the contractual relationship as well as to third party beneficiaries of the ISDA Agreement.⁸⁴

Orange County⁸⁵

Orange County involved structured notes called inverse floaters⁸⁶ and in December 1994 reported a large loss in its investment pool that led to the bankruptcy of the county shortly thereafter.⁸⁷ The Treasurer of Orange County apparently had

the authority to enter into these transactions, so an ultra vires claim would not be successful. Guided by his investment bankers he sought to maximise the gains by aggressive use of leverage, borrowing against the assets of the portfolio. The issue at hand was whether Orange County violated the California Constitutional debt limitations and whether it had authority to enter into such borrowing.

Orange County had failed to surround the treasurer with a compensating infrastructure of strict investment policies, risk controls, regular and detailed reporting and independent oversight.⁸⁸ The bankruptcy disrupted the national municipal bond market. Its aftermath included reforms in the governance structure including oversight committees, long-range financial planning, auditing and stricter investment policy. In June 1998, Orange County reached a settlement with Merrill Lynch after a claim against the latter of steering the treasurer towards risky and unsuitable investments. While Merrill Lynch claimed that it warned an experienced investor of the dangers of leverage, it never informed the Board of Supervisors of its alleged concerns.⁸⁹

As the aforementioned cases clearly indicate, claims are commonly invoked when the swap has not been profitable, so as to mitigate the ensuing losses. An end-user's claim will be stronger in circumstances where material misrepresentation, fiduciary relationship between end-user and dealer and non-disclosure can be proved, while a claim premised only on issues relating to suitability or lack of authority to enter the transaction will usually be relatively weak.

Conclusion

From the discussion in this article we can draw some conclusions regarding the emerging legal standards governing OTC derivatives transactions. Derivatives dealers face threat of liability to the sophisticated investors under the various liability claims analysed in this article. This uncertainty intensifies the overall risk inherent in these transactions even for the most conscientious financial institutions.

In order to prevent enforceability claims from arising, end-users could:

- maintain internal controls;
- periodically mark to market their derivatives transactions;
- forecast their funding requirements;

88. Lack of internal controls was also an issue in the Barings débâcle.

89. "Orange County", www.erisk.com/LearningCenter/CaseStudies/orangecounty.pdf.

81. *Adimitra (PT) Rayapratama (AR) v Bankers Co and BTI* (US District Court for the Southern District of New York), August 16, 1995.

82. US District Court for the Southern District of New York.

83. Adimitra sought to avail itself of RICO, giving it the possibility of being awarded treble damages. See further Henderson, fn.30 above, at p.236.

84. Like BT in this case.

85. *Orange County Investment Pool v Merrill Lynch & Co*, fn.4 above.

86. Their return decreases as interest rates increase.

87. Congress enacted a revised Municipal Bankruptcy Act in 1937 which most recently amended in 1994 as part of the Bankruptcy Reform Act of 1994. Municipality bankruptcy is handled by Chapter 9 of the US bankruptcy code.

- adopt internal controls with respect to their derivatives activities.

Similarly, dealers could:

- include in ISDA agreements representations that illuminate the particular risks and accounting decisions that the counterparty must analyse and decide upon;
- clarify issues related to the dealer's authority to enter into binding agreement;
- establish more stringent internal controls;
- examine the credit rating of counterparties.

Although cases such as *P&G* and *Dharmala* provided some reassurances of reducing legal uncertainty, there is much to be done regarding the regulatory framework. In August 1995 *The Principles and Practices for Wholesale Market Transactions* was published,⁹⁰ clarifying the nature of the arm's length relationship between

90. By ISDA, New York Clearing House Association, Public Securities Association, Foreign Exchange Committee of the Federal Reserve Bank of New York, Securities Industry Association, Emerging Markets Traders' Association.

dealers and investors and setting out standards of fair dealing with each party determining its own capacity, and policies.⁹¹ Open issues such as deficient definition of derivatives, insufficient measures of risk and incomplete accounting standards need to be dealt with. Means to tackle such issues and enhance legal certainty include improvements in documentation, the creation of a clearing house for derivatives and possibly the existence of different rules for the distinct derivatives markets.

Certainty, especially legal certainty, in the world of finance is a precious yet often scarce commodity. It is, however, of grave importance for the development of OTC derivatives markets.

91. Other similar attempts include the London Code of Conduct by the Bank of England and the 1993 discussion paper by the Financial Panel Law in England on duties and liabilities of a bank or non-bank dealer to its derivatives customers. In March 1995 the six major firms active in OTC derivatives transactions in co-operation with the SEC and CFTC, adopted the *Framework for Voluntary Oversight* which taking an "arm's length approach", imposed obligations on dealers related to management controls, disclosures to non-professional counterparties.

Appendix

In this part of the article, the definitions⁹² of the main types of swaps are presented.

- (1) *Interest rate swap*: agreements between parties to make periodic payments to the other party in the same currency corresponding to different securities without actually exchanging securities directly.
- (2) *Currency swap*: the two parties make periodic payments based on notional amounts in two different currencies and a fixed or floating rate of interest.
- (3) *Foreign exchange swaps*: akin to currency swaps that entail exchange of stipulated amounts of two currencies at one or more future dates at predetermined exchange rates.
- (4) *Equity swaps*: the two parties make periodic payments based on the value of a given equity index or basket of equity shares and on a fixed or floating interest rate on a notional principal amount.
- (5) *Diff swaps*: entail an exchange of interest payments calculated with respect to different currencies but paid in one currency.⁹³
- (6) *Credit default swaps*: involve one party making regular payments but receiving nothing in return unless default occurs. They are a form of insurance contract for which each regular payment is a premium and the default is the contingency being insured against.
- (7) *Total return swaps*: involve an exchange of the flows of returns on two assets (usually credit instruments) and transfer both credit and market risk.

92. Z. Bodie, A. Kane and A. Marcus, *Investments* (4th edn, Irwin McGraw-Hill, Singapore, 1999), p.935.

93. As in *Procter and Gamble v Bankers Trust Company*, fn.77 above; *Scott and Wellons*, fn.39 above, at p.1047.