

### 3.22 *The third and fourth waves of innovation*

parties have a 1992/2002 ISDA master agreement between themselves. Those using a European master agreement, for instance, might have pause. Fourth, selecting an early termination date as a date in the distant past has all the disadvantages and contractual problems discussed in chapter 19, para 19.4, with respect to automatic early termination.

As noted in chapter 15, para 15.6, the US Internal Revenue Service issued Rev. Rul. 2008-31 providing that swaps relating to “an index based on data from a geographically and numerically broad range of United States real estate” did not create interests in US real property for purposes of US tax laws.

<sup>1</sup> Interpretive Letter 1081, 2007-06-11. The OCC approved these derivatives for US banks on a customer-driven intermediated basis.

<sup>2</sup> ISDA has also published forms for specific use with some of the indices.

### CONCLUSION

3.23 The derivative has come a long way from that documentation gimmick used to facilitate back-to-back loans in London.

## Chapter 4

# EQUITY DERIVATIVES

4.1 Options and futures related to stocks and equity indices are by no means recent products. They have been traded on US and other exchanges for many years; some observers mistakenly view them as the products on which the OTC derivatives markets were based.<sup>1</sup> An active market in OTC, privately negotiated, cash and physically-settled equity options and equity swaps was, however, developed only in the late 1980s and early 1990s. At the end of 2009, there were \$6.591 trillion of aggregate notional amounts of equity derivatives outstanding, down from \$10.177 trillion at 30 June 2008. The most popular structure was the option, at \$4.762 trillion, with forwards and swaps making up the balance.<sup>2</sup>

The attractions of OTC equity derivatives include those common to all derivatives, such as ease and speed of execution, decreased transaction costs, flexibility of terms and leverage. As with all derivatives, equity derivatives can be used to hedge positions, take an open position or achieve regulatory, tax or accounting goals. Some of these will be discussed under the relevant product headings (option, swaps and forwards).

In 1992, ISDA published a long form confirmation for equity index transactions, reflecting the early market practice. In 1994, it published the equity option definitions, followed quickly by the 1996 ISDA equity derivatives definitions that supplanted both. The 1996 equity definitions provided for:

- cash or physically-settled equity options;
- cash settled equity swaps;
- use of a single share, an equity index,<sup>3</sup> or a basket<sup>4</sup> of shares or indices; and
- a series of consequences and fallbacks on the occurrence of a range of unexpected events which could affect valuation, settlement or hedging.

The 2002 ISDA equity derivatives definitions substantially revised the 1996 equity definitions providing for:

- a new structure, a forward, which may be cash or physically-settled and may have a cap and floor;
- the availability of ‘barrier’ features;
- physical settlement for equity swaps;
- an election for a party to select the form of settlement prior to the settlement date;

- a substantially increased role, together with substantially increased discretion, for the calculation agent (and for a new hedging party and a new determining party that would, presumably, be the dealer party that is the calculation agent, with provision for joint determining parties); and
- substantial refinement, updating and expansion of the disruption and fallback provisions, with an increased emphasis on the dealer's hedging.

A user's guide to the 2002 equity definitions was subsequently published. In a departure from prior practice, 18 forms of equity derivative confirmation were also subsequently published on the ISDA website rather than appended to the definitions themselves. This may have been because they were not yet ready or their length would have more than doubled the size of the definitions booklet, or both.

Starting in 2004, ISDA published master confirmation agreements, all revised several times since original publication. These provide for standardised selection of terms and special terms applicable to equities and equity indices in the relevant geographic area. There are master confirmation agreements for:

- the Americas (the United States and Canada):
  - revised 2004 Americas interdealer master equity derivatives confirmation agreement, covering cash-settled European/American index options, cash-settled index swap/index basket swaps, cash or physically-settled European/American share options, cash-settled share swap/share basket swaps, cash-settled index variance swaps and cash-settled share variance swaps on US underliers with a supplement for Canadian underliers;
  - stand-alone 2007 Americas master variance swap confirmation agreement, covering cash-settled index variance swaps and cash-settled share variance swaps on US underliers with hedge funds;
  - 2008 Americas master designated/exchange-traded contract option confirmation agreement, covering physically-settled share option transactions and cash-settled index option transactions that reference listed share options and listed index options on US underliers; and
  - 2009 Americas master equity derivatives confirmation agreement, covering cash-settled single share swaps, cash-settled exchange-traded contract index options and physically-settled designated contract share options on US underliers.
- Asia, excluding Japan (AEJ) (reflecting changes made to prior agreements by the 2009 ISDA AEJ derivatives protocol published 9 March 2009, which also incorporated the revised additional provisions for use with Indian underliers)
  - revised 2008 AEJ master equity derivatives confirmation agreement, including: the multiple exchange index annex; Annex CMISO, referencing closed markets in India, Indonesia, Korea, Malaysia, Taiwan and Thailand; and the open market annex OMISO, which documents cash and physically-settled European and American style index and share options, and the open market

- annex OMEFS, which documents cash-settled equity finance share swaps, in each case with respect to underlyings in Australia, Hong Kong, New Zealand or Singapore;
- second revised AEJ interdealer master equity derivatives confirmation agreement, covering index and share options and swaps in the interdealer market with respect to underlyings in Australia, Hong Kong, India, Indonesia, Korea, Malaysia, New Zealand, Singapore, Taiwan and Thailand;
- AEJ master variance swap confirmation agreement and AEJ master equity derivatives confirmation agreement, revised most recently to give effect to the 28 December 28 2009 ISDA Market Practice Statement with respect to market disruption for Australian shares, covering cash-settled index and share variance swaps with respect to underlyings in Australia, Hong Kong, India, Indonesia, Korea, Malaysia, New Zealand, Singapore, Taiwan and Thailand; and
- the revised (June 2009) ISDA AEJ reference price source matrix, for use with the above.
- Europe:
  - European master equity confirmation agreement, covering options on a European index or share, including a multiple exchange index annex (replacing the provisions of exhibit H of the user's guide discussed above) and an index/share option annex) as well as cash-settled equity finance share swaps (total return swaps); and
  - revised 2007 European variance swap master confirmation agreement, providing for index and share variance swap transactions, and the recently published ISDA standard terms appendix for variance option under the European variance master.
- Japan:
  - 2005 Japanese interdealer master equity derivatives confirmation agreement, covering cash-settled index options and physically-settled share options on Japanese underliers in the Japanese interdealer market;
  - 2008 Japanese master equity derivatives confirmation agreement, covering cash-settled index options and cash or physically-settled share option transactions on Japanese underliers;
  - 2008 Japanese dividend swap master confirmation agreement, covering index dividend swaps based on a Japanese index;
  - 2006 Japan interdealer master variance swap confirmation agreement, covering index and share variance swaps with respect to a Japanese underlying, and 2006 Japan master variance swap confirmation agreement that is identical to it other than in respect of the appointment of the calculation agent.

In March 2009, ISDA published a matrix illustrating the different products covered by the regional master confirmation agreements, including variance swaps and depository receipt look through provisions. These are discussed throughout the chapter and in para 4.20.

One may conclude, non-controversially, that the equity definitions have not become less complex. Those not regularly active in the equity derivatives

market must study the definitions with care. There are many selections to be made, many of which have significant ramifications for exposure. If these are ignored or not agreed at the time of entry into an equity derivative transaction, a party may find itself bound by provisions desired by the party preparing the confirmation. But even this review is not enough. As the 2002 definitions contain some mistakes and reflect global market practice (which will vary from jurisdiction to jurisdiction), the user's guide and confirmation forms, which correct some of the mistakes, and the regional master confirmation agreements, which illustrate local variations in practice, must also be reviewed. The global standard definitions often require adjustment in particular jurisdictions, as illustrated by the master confirmation agreements. Local counsel and the traders familiar with the local exchange conventions must review the definitions closely in this context. It is a mistake to think that because they are standard they can be safely used in any equity market.

Further, an end-user will wish carefully to consider two issues in particular under the 2002 definitions: the discretion given to the calculation agent and the rights of the hedging party and the determining party, new concepts in the ISDA definition booklet structure.

The calculation agent, presumably the dealer, has extraordinary discretion in relation to valuations, disruption events and extraordinary events, as will be evident in analysing the definitions. The 2009 Americas master confirmation agreement drives this point home by providing for the calculation agent to make all determinations not expressly stated to be made by one of the parties. The definitions provide that the calculation agent is not a fiduciary for either party and must act in good faith and a commercially reasonable manner. This provision is a good one, but the other party may require a further provision requiring the calculation agent, in acting in a commercially reasonable manner, to do so after considering the interests of both parties; what is commercially reasonable for a dealer is not necessarily commercially reasonable for an end-user. If this is not acceptable to the dealer, the end-user may require a provision that the calculation agent does not represent the interests of either party. The other party may further require a dispute resolution clause. These issues are discussed more fully in chapter 17, para 17.5.

The hedging party and determining party are designated in the confirmation, and are intended to be the dealer. The hedging party is used in and protected by the additional disruption events discussed in para 4.16 below. The determining party is used in the definition of cancellation amount and is the party entitled to determine the termination value of the transaction, from its perspective, under certain stress circumstances, regardless of which party is affected by the stress circumstances. The implications of these provisions are discussed in para 4.17 below.

<sup>1</sup> As noted in chapter 1, the swap market developed out of the back-to-back loan in London in the mid-1970s. It is, however, fair to say that the advancement in hedging and pricing techniques in the OTC derivatives markets in the early to mid-1980s was patterned on the exchange-traded models.

<sup>2</sup> BIS *OTC Derivatives Market Activity in the Second Half of 2009*. US banks and their affiliates for many years were prohibited from or restricted in engaging in the securities business in the US. This raised some issues with respect to bank participation in the equity derivatives market. In the early 1990s, certain securities activities were permitted to certain bank affiliates and more recently the prohibition has, for all practical purposes, been abolished. Enabling laws and regulations, however, require the separation of the banking and

securities activities. The *OCC Bank Trading and Derivatives Report: Fourth Quarter 2009* estimates the breakdown of notional amounts of equity contracts (including exchange traded) by maturities at 31 December 2009 for the top five banks was:

- less than one year, \$302.99 billion;
- one to five years, \$215.61 billion; and
- over five years, \$77.317 billion.

Revenues from equity trading positions of US banks in the fourth quarter of 2009 was \$144 million, down from an average of \$271 million over the preceding 12 quarters.

<sup>3</sup> Note that an index sponsor usually requires that a licence be obtained before launching and marketing a product linked to the index. Licence fees are not *de minimis*.

<sup>4</sup> If a basket, each share or index is weighted as set forth in the confirmation.

## BACKGROUND DEFINITIONS

4.2 The 2002 equity definitions reflect the significance for a dealer of the exchanges and clearing systems, their opening hours and unimpaired trading and settlement on them, not only for pricing and settlement, but also in hedging. There are a number of critical 'background' terms in the definitions.

- 'Exchange', in relation to a share or index or shares underlying an index, is the exchange specified as such in the confirmation or any successor on which the shares are traded and which the calculation agent determines has comparable liquidity. The 2009 Americas master confirmation agreement provides that, for cash-settled swaps, the calculation agent determines it as the exchange or quotations system on which the shares are listed and traded.
- 'Related exchange', in relation to shares or an index, is the exchange specified as such in the confirmation or any successor on which futures or options on the shares or index are traded and which the calculation agent determines has comparable liquidity. If 'all exchanges' is specified for related exchange, as in the 2009 Americas master confirmation agreement, a related exchange includes each exchange determined by the calculation agent as having a material impact on the trading of such futures or options. I have heard some people suggest that, since the closure of the New York Stock Exchange would disrupt trading on London futures exchanges, it could be related exchange under 'all exchanges'. This does not seem to be the intent, but the possibility illustrates the broad discretion given the calculation agent.
- 'Scheduled trading day' is a day on which each exchange and related exchange is scheduled to be open.
- 'Scheduled closing time' is the scheduled weekday closing time of an exchange or related exchange without regard to extended or after-hours trading.
- 'Exchange business day' is a scheduled trading day on which an exchange or related exchange is open, notwithstanding an early closing.
- 'Clearance system', in relation to a share, is the clearance system specified as such in the confirmation or any successor as determined by the calculation agent or, if not specified, the principal domestic clearance system for the share (and, if a clearance system ceases to settle shares, the system determined by good faith negotiations between the parties).
- 'Clearance system business day' is a day on which the clearance system is open or would have been open but for a settlement disruption.

- 'Settlement cycle' is the period following a trade in relevant shares or an exchange-traded contract (described below) for settlement in accordance with the relevant exchange or, if there is more than one relevant exchange with respect to an index, the longest such period.
- 'Settlement currency' is the currency specified in the confirmation, and is the currency in which cash-settled deals are settled and other amounts are paid. If not specified, there is no defined fallback and hence no settlement currency. The European master confirmation agreement wisely provides a fallback, if not otherwise specified, as the currency in which the shares or index is expressed.

The separate definitions of scheduled trading day and exchange business day were required because of a flaw in the 1996 equity definitions, which used just one term: exchange business day. This simply did not work if there was a market disruption and a given exchange did not open that day. For example, on 9/11, the New York Stock Exchange did not open. Was this a non-business day or a disrupted day? The answer had significant ramifications on expiration of options and valuation (see below). At open meetings, a consensus was reached to treat the event as a non-business day, so that relevant actions were simply deferred to the next day on which the exchange was open. Market rumour was that some parties refused to accept this conclusion and were paid out.

## THE PRODUCTS

4.3 The basic forms covered by the 2002 equity definitions are the option, the swap and the forward. Before looking at specific products, two examples illustrate a principal benefit, and in the view of some persons a systemic problem, inherent in the OTC derivative: non-public position-taking.

An end-user may wish to take a substantial position with respect to a particular share but may be concerned that doing so on the stock, futures or options exchanges would move the market to its disadvantage. It may prefer to enter into an OTC transaction in which the dealer counterparty will hedge its exposure through methods with substantially reduced market impact.<sup>1</sup> Using Black-Scholes models to determine the 'Delta', an option position can be hedged by holding or selling short, depending on whether the hedging party has sold a call or a put, between 0 and 1 share per single share option position. If the delta is low, say 0.3, ten options can be hedged temporarily by three shares. An illustration was provided in *Caiola v Citibank NA* 137 F Supp 2d 362 (SDNY, 2001); 295 F 2d 312 (2nd Cir, 2002), primarily discussed in chapter 10:

'Citibank promised Caiola that as his counterparty it would control its own risks through a strategy known as "delta hedging". Delta hedging makes a derivative position, such as an option position, immune to small changes in the price of an underlying asset, such as a stock, over a short period of time . . . The "delta"

measures the sensitivity of the price of the derivative to the change in the price of the underlying asset . . . Specifically, "delta" is the ratio of the change in the price of the derivative to that of the underlying asset . . . Thus, if an option has a delta of .5, a \$1 change in the stock price would result in a \$.50 change in the option price. Caiola's synthetic positions contained a number of components, such as a stock position plus one or more option positions. For each of these coupled or integrated transactions a "net delta" was calculated which helped Citibank determine the amount of securities necessary to establish its "delta core" position. By maintaining a "delta core" position in the physical market, Citibank could achieve "delta neutrality", a hedge position that would offset Citibank's obligations to Caiola.

Effective delta hedging is a sophisticated trading activity that involves the continuous realignment of the hedge's portfolio. Because the delta changes with movements in the price of the underlying asset, the size of the delta core position also constantly changes. Although a certain delta core position might sufficiently hedge Citibank's obligations at one point, a different delta core position may become necessary a short time later . . . Thus, as markets fluctuate, the net delta must be readjusted continuously to ensure an optimal exposure to risk . . . Citibank told Caiola that as his counterparty it would continuously adjust its delta core positions to maintain delta neutrality. Also, Caiola routinely altered his transactions to account for their effect on Citibank's delta core positions. This arrangement was satisfactory so long as Citibank adhered to its delta hedging strategy, which involved comparably small purchases in the physical market. However, if Citibank fully replicated Caiola's stock and option options in the physical market instead of delta hedging, the benefits of synthetic trading would disappear and he would be exposed to risks that this strategy was designed to avoid.'

Another use would be to accumulate, notionally, a position pending a takeover offer. Most jurisdictions have laws requiring potential acquirers to file or otherwise make public disclosure once their share holdings in a potential target reach a certain percentage of the target's outstanding shares, often 5%. Once disclosure has been made, the market is aware of the possible takeover and the share price may rise, to the acquirer's detriment in further share purchases. If the acquirer can lock-in a value for the shares through an OTC derivative, it can avoid some of the negative effects of the required disclosure. Two cases, *Ithaca (Custodians) Ltd v Perry Corporation* [2003] 2 NZLR 216, reversed on appeal November 2003, and *CSX Corporation v The Children's Investment Fund Management (UK) LLP and others* (2008 U.S. Dist. LEXIS 46039; Fed. Sec. L. Rep. (CCH) P94, 748), both primarily discussed in chapter 10, para 10.6, illustrate the risks in this, perhaps too-clever, use of derivatives. The Dodd-Frank Act, primarily discussed in chapter 12, para 12.67, authorises the Securities and Exchange Commission to expand the beneficial ownership of securities to include those subject to a swap.

<sup>1</sup> Dynamic hedging may also result in consequential trading that exacerbates sharp market movements. For example, if the hedging party is holding shares and there is a sudden market movement, he is selling into a falling market or buying into a rising market. Similarly, if there is an overnight price decline, he is exposed.

## Options

4.4 An end-user buyer of an option can speculate on (or, if one prefers, invest in) the rise or fall in the value of shares or a share index or hedge its other

## LEGAL RISK: THE LAW, CERTAINTY AND DERIVATIVES

10.1 Legal risk has hovered over the derivatives markets since the first swap. The inherent difficulty in dealing with novel products and the additional difficulty of categorising derivatives combine to make this one of the more interesting aspects of a study of derivatives. Legal risk is a broad, imprecise concept used to describe the possibility of loss arising from unenforceability of contract terms and from other exposure to loss, liability or sanction by reason of the application of laws, regulations or their interpretation. The risk may arise from:

- insolvency laws which, in addition to the conventional risk of deferred and reduced recoveries (which is generally capable of being modelled), may result in an increase of the *amount* of a party's derivatives credit exposure through the unenforceability of close-out netting;
- financial regulatory laws and regulations, unanticipated application to derivatives of laws and regulations intended to apply to other activities, or judicially imposed duties;
- a counterparty's lack of capacity or authority to enter into derivatives;
- taxation applied on an unexpected basis;
- faulty, inadequate, inconsistent or incomplete documentation;
- failure to comply with legally required procedures; and
- erratic or unpredictable judicial decisions and regulatory interpretations due to lack of precedent or arbitrariness.

There is a thought that the most fundamentally important attribute of the law is that it be certain; fairness is a highly desirable but (putting aside gross inequities and oppression) secondary attribute. If the law is certain, people can arrange their affairs in advance to comply, even if the law is unfair. If it is fair but not certain, people are not able properly to order their affairs, and the lack of predictability itself becomes an inequity. There is some merit to this thought, at least when applied to derivatives. Prerequisites for a global dealing business include, in addition to the transparency, speed of execution and liquidity critical for the free flow of capital, sufficient certainty as to enforcement, regulation and taxation so that financial institutions in a given jurisdiction are able to run a global book efficiently and to remain competitive with financial institutions from other jurisdictions. At a minimum, sufficient certainty is required in these respects to permit local end-users to benefit from the free and efficient flow of capital provided by the major international dealers.<sup>1</sup>

Over the history of the derivatives markets, the greatest legal risks have arisen from the uncertainty of the law,<sup>2</sup> the failure to clarify the nature of derivatives under existing legal systems. In fact, some distinguish between risk and uncertainty. Risk is a quantifiable concept that can be modelled and priced either through statistical hindsight or actuarial processes. It does not inhibit dealers; it is what they trade.<sup>3</sup> Uncertainty and unquantifiable probability are different. Uncertainty is at a minimum an inhibition on the efficient use of derivatives; at its worst, it could result (and has resulted) in significant losses. In the absence of total clarity, the risk might in some cases still be reduced to one that is commercially acceptable. Indeed, it has been the calculated and determined adherence to the acceptance of 'commercially acceptable' legal risk that permitted the market to develop through so many years of uncertainty.<sup>4</sup>

<sup>1</sup> For instance, modelling will be more difficult and pricing less efficient if a counterparty has technical defences to payment and other possible means of avoiding liability.

<sup>2</sup> There have in fact been actual losses in this regard, but in retrospect not such as rose to the level of crisis. One can imagine worse. Contemplate with horror:

- the unenforceability of close-out netting in a major dealer jurisdiction and the result it would have on global credit risk (see chapter 11);
- the unenforceability of all derivatives in the US because they constitute illegal off-exchange futures (see chapter 12);
- the classification of derivatives as insurance contracts (see chapter 12);
- the unenforceability of derivatives against a major class of end-users because of their lack of capacity (see chapter 13); or
- the determination that withholding taxes are applicable to payments under derivatives in a major dealer jurisdiction (see chapter 15).

<sup>3</sup> Some dealers have given thought to quantifying legal risk, without much success, at least yet. The best they could come up with was using an arbitrary figure. This is not unlike the approach of the regulators, discussed in chapter 12, para 12.55, with respect to operational risk (which to them includes legal risk). That having been said, data is being collected in order to provide the basis for models on operational risk.

<sup>4</sup> In retrospect, it is also interesting to observe how the derivatives markets grew and continued to grow during periods of uncertainty. It may be, qualifying the assertion above, that manageable uncertainty, at least as long as the regulators take a relaxed approach, is less an inhibition than over-regulation.

## CAUSES OF LEGAL UNCERTAINTY

10.2 The legal analysis of mature financial products in established financial markets is relatively straightforward. The pitfalls, although interesting, still evolving and sometimes substantial, are generally widely understood. Issues relating to enforcement, regulation and tax are publicly identified and market-acceptable procedures will have evolved to comply with the resulting requirements. The legal analysis of innovative products in either established or emerging financial markets is more difficult, and uncertainties may result in adverse characterisations of transactions not contemplated by the existing legal framework. The difficulty is not lessened by the evolution of derivatives into a technology rather than a defined set of products. The flexibility inherent in this technology, as illustrated by the preceding chapters, may make a derivative appear similar to a recognised product or amenable to use as a means of evading unfavourable legal treatment with respect to another type of product. The protean nature of derivatives and their use in conjunction with or in relation to many other clearly recognised products or recognised markets greatly complicate any effort to categorise or define 'derivatives' within different legal contexts.

The absence of legal recognition of an innovative product may or may not present opportunities to a creative user of derivatives, but it will certainly present challenges. Old laws and regulations may simply not contemplate new products or new refinements of old products. Governmental authorities may be faced with a limitation on staff and resources that curtails their ability adequately to analyse the product and its effects on the markets, particularly where the risks are not intuitively obvious or involve complex models. Competing agencies may each, with some legal basis, claim jurisdiction in an effort to protect bureaucratic 'turf'. An agency may have jurisdiction over a particular industry towards which it takes a protective attitude, resulting in a narrow approach that may discourage analysis and results which are best for society or the financial markets as a whole. There may be a legitimate concern of regulatory or taxing authorities over reaching an administrative result which is favourable and appropriate for the new product but may establish undesirable precedents with respect either to somewhat similar but essentially different instruments or to further anticipated (or feared) refinements of the new product itself. There may be a fear, perhaps not unjustified, that an innovative, complex product is intended to get around an existing regulation or tax in order to defeat the goals of the particular legal regime. These factors may lead regulators, tax authorities and courts to be both suspicious and cautious when dealing with derivatives and related products, and reluctant to take definitive positions.

From a different perspective, a court or government official may attempt to apply principles developed with respect to other products offered in other contexts or may have difficulty in determining which existing products are relevant by way of precedent. Judges trained in an earlier era may fail to grasp the essence of the new technology. Absence of judicial precedent may make it impossible to opine on a predictable basis and in an informed manner on how a new product will be enforced.<sup>1</sup>

The global nature of the derivatives markets further complicates the task of creating or interpreting the law in respect of derivatives. Regulators or tax authorities will wish to consider the level of regulation or tax in other jurisdictions in addressing the appropriate treatment in their own. A judge may consider the international reputation of the local judiciary as a forum for settling disputes. Business may be driven to those jurisdictions that allow greater freedom, fewer burdens, greater clarity and more certain enforcement.

Although no oversimplification will apply to all products, there may be a product life cycle, moving from first issue or transaction, to public awareness, to market acceptance and finally to established dealing groups and procedures. There may be a parallel legal cycle. First, new instruments are devised on a case-by-case basis, often apparently outside the scope of existing enforcement, regulatory or tax or systems, in order to solve a particular problem or to take advantage of gaps or anomalies in particular markets. The early transactions are structured as closely as possible to conform to existing products which have relatively predictable legal consequences, although there will likely be doubts in 'grey areas' of enforcement, regulation and tax due to the lack of exact precedent. Gradually, the product comes to be viewed as a 'normal' product in its own right and volume grows, even though the grey areas remain. At this stage, however, the size of the emerging market, the number of major institutions involved and the potential damage that could result from adverse

action may as a practical matter restrict the ability of a government and, to a lesser degree, its courts to prohibit or impair the product. The focus shifts to revising the larger regulatory, tax and enforcement structures, often many years later, to accommodate and integrate the product.

This part III will deal with the way derivatives have been integrated into the legal systems of many jurisdictions. In this process, ISDA has been instrumental in working with legislators, regulators and tax authorities to improve their understanding of derivatives and in helping to develop user-friendly derivatives legislation and regulation in many jurisdictions.

Before turning to discussion of specific areas in which the legal nature of derivatives has been questioned and, in many cases, clarified, two 'overview' issues will be discussed: the difficulty in characterising derivatives, and case studies in how they can be misused, particularly in structured transactions; and the formal way in which major dealers and active end-users seek to control the legal risk in derivatives.

<sup>1</sup> It was and remains useful to remember in this context that a derivative is just a contract.

## RECHARACTERISATION AND ABUSE

10.3 Several of the major legal issues relating to derivatives may be reduced to the single question: 'What are they?' This question of characterisation will arise in many different contexts, particularly in structured transactions or other transactions intended to take advantage of accounting, regulatory or tax opportunities. Part II contained many examples of the positive benefits of derivatives in this regard. Any discussion of the legal risk in derivatives would, however, be deficient without a mention of the dangers in playing too close to the boundaries or in fact misusing derivatives. Many otherwise financially sophisticated regulators, authorities and judges, along with many financial lawyers and accountants, approach derivatives with trepidation. This results in a disengagement that can be turned to advantage by the unscrupulous. Derivatives, since they are often poorly understood, are uniquely suited for use by parties who seek to create misleading structures. They can always state that the complexities are inherent in derivatives and the conventions in 'the derivatives market' are a certain way. The 'uninitiated' simply nod and cease their analysis. This is not a 'problem' or risk with respect to derivatives as such, but it should induce caution in those who must analyse structures that might be used for purposes which, even if technically legal, may be questionable.

### Recharacterisation

10.4 A concern with all derivatives is the risk that a structure will be recharacterised in a manner adverse to the interests of one or both of the parties. A regulator, tax authority, accountant or judge might look through the structure to the physical activity replicated or otherwise ignore the form. This risk is increased in many structured financings where the intent of the parties may in fact have been lawfully to circumvent the effects of a given law, tax, accounting result or judicial power.

For instance, a court could choose to recharacterise a physically-settled, total return credit derivative, which is preceded by a sale of the reference obligation

to the protection buyer, as a secured loan to the protection seller. If, then, there were registration or filing requirements or other formalities with respect to secured borrowings of the protection seller with which the protection buyer had not complied, there would be a risk that other creditors of the protection seller might have recourse to the reference obligations. If there were margin requirements imposed by the application of laws that had not been analysed, both parties might find themselves in regulatory difficulties. Another interesting question, to which it is difficult to see a firm answer, is whether such a transaction might be prohibited by provisions in other contracts restricting the protection seller in borrowing money or securing its debt.

Of particular concern in structured financial arrangements that are intended to 'get around' some impediment or inconvenience is the risk that the relevant governmental authority will apply a 'substance over form' test. In the UK, the courts have traditionally upheld the agreed form of a transaction if there is a workable rationale for it. A leading English case dealing with recharacterisation is *Welsh Development Agency v Export Finance Co Ltd*.<sup>1</sup> The Export Finance Co Ltd (Exfinco) funded an English exporter through 'purchasing' the product that the exporter then sold on Exfinco's behalf. The exporter had charged its book debts (with proper registration) to the Welsh Development Agency. On the exporter's insolvency, the Welsh Development Agency claimed a right under the charge and priority over monies payable by the foreign purchasers. The issue was whether or not the structure created by the exporter and Exfinco:

- would be upheld, in which case those monies would be owing to Exfinco; or
- recharacterised as a loan and security arrangement, in which case the monies would be owing to the exporter subject to the charge of the Welsh Development Agency, with Exfinco's resulting security interest failing for lack of registration.

The lower court set aside the structure and found for the Welsh Development Agency. The Court of Appeal reversed, even though it found that 'the master agreement is a document of remarkable complexity and the complexity is increased by the fact that the draftsman has sought to get the best of all possible worlds'. The court was therefore under no illusions as to the intent of the structure. Dillon LJ said:

'Thus the task of looking for the substance of the parties' agreement and disregarding the labels they have used may arise in a case where their written agreement is a sham intended to mask their true agreement. The task of the courts there is to discover by extrinsic evidence what their true agreement was and to disregard, if inconsistent with the true agreement, the written words of the sham agreement . . .

. . . But the question can also arise where, without any question of sham, there is some objective criterion in law by which the court can test whether the agreement the parties have made does or does not fall into the legal category in which the parties have sought to place their agreement.'

The court found that the structure, viewed objectively, 'worked' as a sale agreement. The fact that it was 'off balance sheet' was irrelevant. Slaughter LJ said, in relation to the aspects of the transaction which were also indicia of loans:

'In my judgement the correct process, when one is following the internal route, is to look at the operative parts of the document, in order to discover what legal transaction they provide for. If some parts appear to be inconsistent with others in this respect, a decision must be made between the two. This is what I understand by ascertaining the substance of the transaction.

But none (of these indicia of loans) is in my opinion inconsistent with a sale.<sup>2</sup>

A US court arrived at a similar result. In *Granite Partners, LP, et al. v Bear, Stearns & Co Inc, et al*, 17 F Supp 2d 275 (SDNY 1998), the plaintiffs were funds that invested in mortgage related securities (CMOs)<sup>3</sup> and filed for bankruptcy in 1994 following the rise in interest rates. Most of the CMO positions were taken through repos. The action was brought against several investment banks that, allegedly and among other things, made improper margin calls and liquidated the plaintiffs reverse repos when margin was not provided. The plaintiffs alleged the repos were in fact collateralised loans. The defendants moved to dismiss parts of the complaint.

The plaintiffs claimed the repos 'were the functional equivalent of secured loans' and the liquidation procedures violated Article 9 of the Uniform Commercial Code. The claim thus depended on the characterisation of the transactions. The court found that the repo characterisation was correct. It defined a repo:

'A repurchase agreement, by its terms, involves two separate but related transactions: (1) a sale by a party (the "repo seller") of securities in exchange for cash and (2) an agreement by the repo seller to repurchase the same or equivalent securities for a specified price at a future date. In a reverse repurchase agreement, the party initially buys the securities in exchange for cash, and incurs a forward obligation to resell them. Every repo is also a reverse repo; that is, a reverse repurchase agreement is simply a repurchase agreement viewed from the perspective of the repo buyer.'

On the recharacterisation issue the court said:

'The key to the inquiry as to whether the repos in this case should be characterized as purchase and sale agreements or secured loans lies in the intention of the parties. Article 9 only applies to transactions in which the parties' intent is to create a security interest . . . . Where the parties' intention is clearly and unambiguously set forth in the agreement, effect must be given to the expressed intent.'

The defendant banks pointed to paragraphs 6 and 8 of the industry standard PSA repo master agreement that said:

' . . . the parties intend that all Transactions hereunder be sales and purchases and not loans . . . .

Title to all Purchased Securities shall pass to Buyer and, unless otherwise agreed by Buyer and Seller, nothing in this Agreement shall preclude Buyer from engaging in repurchase transactions with the Purchased Securities or otherwise pledging or hypothecating the Purchased Securities.'

The plaintiffs responded:

'[T]he contracts reflect the parties understanding that the Funds' repos were the functional equivalent of secured loans, [and] extrinsic evidence will indicate that the Brokers viewed their repos as collateralized loans, and a finding that repurchase agreements are purchases and sales can only be accomplished after a careful consideration of all of the evidence on a more fully-developed record.'

The court disagreed because of the clear and unambiguous statements in the PSA agreement. It was also influenced by the fact that the PSA agreement was an industry standard agreement.

'Policy considerations and trade custom and usage support such a finding. Moreover, ignoring the affirmative intent of the parties would inject unpredictability and insecurity in the manner by which major financial institutions obtain credit. The decision by market participants to enter into a repo transaction documented using the PSA Agreement, structured as a purchase and sale, thus carries with it a wide variety of legal and regulatory consequences. Market participants who prefer to enter into secured lending transactions rather than repos may do so (with the attendant legal result that their transaction will be treated as a loan); participants who prefer to enter into a sale and wholly distinct forward purchase (with attendant legal consequences) may also do so. The determination of market participants that elect to enter into a repo transaction has been and should be respected and their settled expectations will not be overturned.'

The court noted some similarities with financings, but focused on their uses in the capital markets that went beyond secured financings. Repos have uses that cannot be fulfilled by secured loans.

'They are a vital and cost-efficient mechanism for broker-dealers to fund their inventory and dealing activities in these securities. The existence of a repo market in a particular type of securities also adds to the liquidity of the underlying cash market for the securities.'

Further, certain arts of Article 9 are consistent with the requirements for speed of execution and liquidation of securities that are necessary attributes of the repo market. Finally, repos were also provided with unique status under the US Bankruptcy Code.

The decision was not, however, absolute protection for all repos in general. One of the defendants had not executed the PSA agreement, but acted under a short trade confirmation with ambiguous language. The court did not dismiss the relevant part of the complaint as to it.

<sup>1</sup> [1992] BCLC 148, [1992] BCC 270, CA.

<sup>2</sup> The English courts have, however, had no difficulty in finding transactions to be loans, although structured as a swap (*Haugesund Kommune, Narvik Kommune v Depfa Acs Bank and Wikborg Rein & Co* [2009] EWHC 2227 (Comm), [2010] EWCA Civ 579, [2010] All ER (D) 273 (May), primarily discussed in chapter 13, para 13.10) or a repo (*Morgan Stanley UK Group v Puglisi*, Queen's Bench Division, Commercial Court, January 1998, primarily discussed in chapter 12, para 12.21).

<sup>3</sup> These were collateralised mortgage obligations, principally issued by Fannie Mae and Freddie Mac, for which see chapter 8, para 8.12 onwards and chapter 12, para 12.62.

## Caiola

10.5 Equity derivatives can be viewed as replicating loans secured by shares of stock. In the US, disregarding the form may have many ramifications, including application of the margin rules restricting leverage and the stringent anti-fraud provisions of the US securities laws. In *Caiola v Citibank NA* 137 F Supp 2d 362 (SDNY, 2001), discussed in chapter 12, para 12.31, the court described an equity swap as replicating a secured loan to buy US shares without complying with the margin provisions of US laws.

The court characterised such swaps as follows:



## CAPACITY AND AUTHORITY

13.1 Few derivatives counterparties are individuals. They tend to be corporations, partnerships, trusts, government agencies or other artificial entities. None of these is a 'thing' or a living person with any physical substance. They may be viewed either as constructs created by and existing only in the law or as shorthand descriptive terms used to describe defined legal relationships among, taking a corporation as an example, people (shareholders, officers and directors, employees and customers), specific assets (plant and equipment) and claims (accounts receivable) and liabilities (taxes, salaries and debt) in respect of other individuals and other legal entities. Such artificial legal entities, by definition, only have the capacity to do things that the statutes creating them have provided. Further, in order to enter into the web of legal relationships created under law, for example as a creditor, it may be necessary to observe certain formalities. If a party lacks the legal capacity to enter into an agreement or if it does not observe the legally required formalities, the legal risks run from:

- unenforceability of the agreement against it:
  - under all circumstances, or
  - under certain circumstances;
- the rendering of enforcement by the counterparty more difficult (there being a broader range of nuisance defences being raised);<sup>1</sup> or
- the party having internal or regulatory problems ranging from minor infractions through imprisonment of officers and directors.

A party (or its insolvency representative) typically only raises its own lack of capacity or authority to enter into a transaction when it is out-of-the-money. On rare occasions, it may be raised by the *other* party, if it is out-of-the-money, claiming release from the contract by reason of lack of mutuality.

In entering into a derivatives relationship, each party will therefore wish to consider its own and its counterparty's legal capacity to enter into the relevant transactions and the corporate formalities required of it to assure that each party is in fact bound by the agreement. Issues relating to legal power and signatories' authority, and board approval will vary from jurisdiction to jurisdiction, as will the means by which a counterparty is able to confirm compliance and the consequences of non-compliance. These issues are a critical part of the due diligence and documentation process and are discussed in that context in chapter 17, para 17.13 through para 17.20.

<sup>1</sup> Further, enforceability of the derivative may be challenged, by an end-user in particular, on the basis that the dealer counterparty owed a duty to the end-user in respect of the derivative,

including a duty not to offer derivatives that were not suitable for it or in conflict with its policies. While a separate issue from authority and capacity and discussed separately in chapter 14, the issues are often raised together.

### POWER AND CAPACITY

13.2 If a legal entity lacks the power or capacity to enter into a transaction, the transaction is said to be '*ultra vires*' or beyond the power of the entity. Many jurisdictions have abolished the concept of *ultra vires* with respect to corporations organised under their laws.<sup>1</sup> Even in these jurisdictions the issue may arise if the constituent documents of a corporation, which are on public record, expressly state that the corporation lacks power to perform certain acts.<sup>2</sup> Further, legal entities other than corporations may still remain subject to the doctrine. As noted above, experience suggests that entities which enter into *ultra vires* contracts rarely discover the lack of capacity when they are in-the-money. It is, for some reason, generally only noticed when they go out-of-the-money.

Generally, the loss occasioned by a finding that a contract is *ultra vires* lies where it falls. The *ultra vires* transaction may be simply viewed as not having existed or *void ab initio* (void from the beginning). Any representations as part of this transaction or claims for damage in respect of it could, by extension, also be viewed as not having existed.<sup>3</sup> In other types of power or capacity questions, the incapacity may only result in the transaction being voidable by the party in question. For the in-the-money counterparty, the distinction may not be terribly relevant, except to the extent that a breach of representation could be found in the latter situation which might result in an independent and enforceable claim for damages by it if acting in good faith. A third type of incapacity may arise where a particular type of transaction is within a party's capacity under some external circumstances but not others. In this situation also, representations and damages clauses may continue to be enforceable as a separate claim. The damages caused to a party acting in good faith by the other party exceeding a capacity limitation may then in effect be shifted back on to the latter.

Finally, substantive laws in a given jurisdiction may limit the power of certain types of legal entity (for example, banks, insurance companies or pension funds). The question then will arise as to whether this limitation is:

- only a restriction on the regulated entity, the breach of which exposes it and perhaps its officers and directors, to sanction;
- a regulatory prohibition, the breach of which would result in a supervening illegality; or
- a fundamental lack of capacity.

An issue of fundamental capacity is generally determined under the laws of the jurisdiction that creates the entity's legal existence. A foreign court is likely to give effect to that jurisdiction's laws in this respect. Regardless of the treatment of an issue of 'regulatory' capacity by a court in the regulating jurisdiction, a court in another jurisdiction might well not give effect to a claim of incapacity,

at least if the relevant performance was required outside the regulating jurisdiction.

<sup>1</sup> For instance, the Delaware Corporation Code provides that a Delaware corporation has all powers of a natural person.

<sup>2</sup> In 1997, Hong Kong amended its Companies Ordinance to permit Hong Kong corporations to have the capacity and power of a natural person. The amendment went on to say, unfortunately, that a company could not perform an act that is not authorised, or which is excluded, by its memorandum and articles of association.

<sup>3</sup> Some English solicitors took the view (perhaps a hopeful one) that even if a counterparty lacked capacity, a breach of a representation in a document separate from the *ultra vires* agreement would provide a separate claim.

### HAMMERSMITH AND FULHAM

13.3 The most significant case dealing with capacity and derivatives remains (*Hazel v The Council of the London Borough of Hammersmith and Fulham, Midland Bank plc, Security Pacific National Bank, Chemical Bank, Barclays Bank plc and Mitsubishi Finance International plc*).<sup>1</sup> Hammersmith and Fulham (the Council) is a London borough, similar to a municipality. During the years 1987 to 1989, the Council had entered into a substantial number of interest rate swaps, swap options, caps, floors, collars, forward rate agreements and gilt and cash options. The aggregate notional amounts of the transactions during those two years was £6 billion (of which a little over £3 billion was still outstanding at 31 March 1989). Based on money actually paid and received to that date, the Council had not lost any money. The mark-to-market position of the Council, or the estimated loss to the Council on a prospective basis was, however, a negative £100 million. The Council had generally taken the position of fixed rate receiver/floating rate payer, and external rates had risen substantially.

The Council's swap activity had occurred in four phases: from December 1983 to March 1987, a total of 23 swaps were entered, 17 in the last year with an aggregate notional amount of £112 million; April 1987 to July 1988, 592 swaps were entered, increasing the outstanding total to £3,727 billion; August 1988 to February 1989, swaps were entered to reduce exposure to rising interest rates; and February 1989 to commencement of the suit, only seven transactions were entered as a result of counterparties exercising existing options to enter into swaps. Most of the swaps were with major international financial institutions that were active participants in the swap market. A number of the transactions were off-market swaps (see chapter 7, para 7.5) and caps written by the Council, in which the Council received an upfront payment. There were clear implications that the Council was using derivatives as a funding tool.<sup>2</sup>

The end of the second phase occurred when the Audit Commission, responsible for auditing the accounts of the Council, obtained the opinions of three leading counsel, one of which stated that all the swaps were unlawful and two of which concurred that most of the swaps were unlawful but disagreed as to the extent to which others were lawful. The auditor informed the Council by letter that he believed a number of the swaps were unlawful. The Council, while not externally acknowledging that the swaps might be unlawful, then undertook to reduce its exposure, while managing existing positions. It closed-out open positions through a variety of transactions, including the

reverse swaps. From that point, the swaps were managed through a capital market fund, established without any approving resolution of the Council. In February 1989 the auditor 'insisted' that the Council cease making payments until the position was clarified.

Ostensibly based on the opinions of counsel and his inability to audit the accounts without certainty as to the liability position of the Council, the auditor applied to the High Court under the Local Government Finance Act 1982 for a declaration that the swaps were unlawful.<sup>3</sup> The ramifications of the case were of course significantly broader than the technically narrow determination of the Council's accounts. The decision would affect whether or not the counterparties to the swaps, primarily major banks, would be able to enforce claims against the Council amounting to approximately £100 million. Furthermore, around 70 other local authorities had also entered into swaps, although on a smaller scale. The Council 'chose' not to dispute the application, no doubt because it was out-of-the-money and, if it were to be excused from performance as a result of incapacity, it might avoid this prospective loss.<sup>4</sup> In order to assure that the case for lawfulness was vigorously presented, a representative group of bank counterparties joined in the proceedings.

The key issues before the court were: whether all or only selected classes of swaps were beyond the powers of the Council; if the answer was that all or some of the swaps were beyond such powers, whether the bank counterparties could nonetheless enforce such swaps if they had not had proper notice of the defect; and whether, if all or some of the swaps were beyond the Council's power, any of the prior payments must be restored.

<sup>1</sup> BC [1991] 1 All ER 545, [1992] 2 AC 1, [1991] 2 WLR 372, HL; rvsg [1990] 3 All ER 33, [1990] 2 QB 697, [1990] 2 WLR 17, 1083, DC and CA.

<sup>2</sup> In *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349, [1998] 4 All ER 513, [1998] 3 WLR 1095, [1999] RVR 315, [1999] LGR 1, Lord Goff characterised swaps of this sort as a form of borrowing.

'Interest rate swaps can fulfil many purposes, ranging from pure speculation to more useful purposes such as the hedging of liabilities. One form of interest rate swap involves an upfront payment, ie a capital sum paid at the outset by one party to the other, which will be balanced by an adjustment of the parties' respective liabilities. The practical result of this is to achieve a form of borrowing. It appears that it was this feature which, in particular, attracted local authorities to enter into transactions of this kind, since they enabled local authorities subject to rate-capping to obtain upfront payments uninhibited by the relevant statutory controls, though they must in the process have been storing up trouble for themselves in the future.'

<sup>3</sup> Undoubtedly, the form of litigation was a sham. If the Council had brought suit, it would in effect have repudiated the contracts, laying itself open to suit by its counterparties. The Council was in fact careful to affirm to all of its counterparties that it fully intended to abide by its *lawful* obligations. All payments by it would be made in escrow. The escrow was simply a book entry on its accounts.

<sup>4</sup> In fact, one can reasonably surmise that the form of the proceeding was instigated by the Council in order to avoid having to deny liability formally or, more accurately, to repudiate the agreements. The lawsuit was effectively brought by the Council against the banks.

### High Court decision

13.4 The High Court first disposed of an argument that the borough encompassed a separate corporation, in addition to the Council, which had

powers beyond that of the Council. Having determined that the Council's functions are confined to those granted explicitly or implicitly by statute, the High Court went on to analyse the basic issue and indicated that counsel prior to the proceedings had put forward three basic opinions:

- a local authority is never capable of entering swaps;
- a local authority can enter a swap in parallel to existing debt which has been lawfully incurred where (i) the aggregate notional principal amounts do not exceed the principal of such debt, and (ii) the profit of the swap is expected to reduce or eliminate the risk of interest variation on the borrowings; and
- a local authority can enter into swaps as part of 'interest rate risk' or 'debt' management.

All concurred that swaps entered for the purpose of making a 'turn' or profit on the swap itself would not be lawful. If the first conclusion above, that a local authority could never enter into a swap was correct, it would follow that the agreements would not be enforceable. If only some swaps were *ultra vires*, the question of enforceability would be in dispute.

The High Court held that all swaps were beyond the power of a local authority. If the Council were to have authority, it must be found in the express power to borrow and lend money. The empowering legislation set forth detailed provisions as to how this could be accomplished, but of course did not refer to swaps. The High Court analysed a number of decisions relating to ancillary activities of local authorities, but concluded that they were not directly relevant since they did not deal with financial activities which were expressly covered in detail by the empowering legislation. The specificity of these laws, including specific means of restructuring debt (a form of debt management), implied that other forms were not permitted. The High Court stated that swaps did not assist the Council in borrowing, drawing a tortured distinction between facilitating the function itself and managing consequences of the function. The High Court concluded that there was not a sufficient nexus between the function, that is, borrowing money, and the swaps, to bring any of the latter into the scope of permitted activities reasonably incidental to the express powers.

Having reached this central conclusion, the High Court addressed other issues as a means of 'assisting' the parties and superior courts on review. First, the High Court found that, even if the Council had the power to enter swaps, there was no proper delegation by the Council to the officers who decided to enter the swaps. Secondly, the establishment of the capital markets fund was unauthorised as a source of payment, and was never validly accomplished. Thus, the source of payments of the swaps was not properly established. Thirdly, the High Court addressed the issue of whether or not the swaps, if they had been capable of entry, had been so unreasonable as to be beyond the Council's powers. In analysing this issue, the High Court looked at the different phases.

In the first phase, the size and number of the swaps did not lead to a conclusion that they were unreasonable.

With respect to the second phase the High Court noted:

- no legal advice was taken as to whether or not the capital markets account fund could be established;
- the Council officers involved were neither trained nor experienced in swap financing;
- the Council itself was not adequately informed; and
- it was also clear that the Council was not engaged in rate management during the 1987/88 period but was speculating in the swaps market with a view to profit.

The swaps in this period were thus not 'reasonable'.

In the third phase, the swaps may or may not have been reasonable, in order to mitigate the effect of the 'unreasonable' swaps. An argument was put forward that transactions entered into for the purpose of mitigating unreasonable, and hence unlawful, transactions could not themselves be reasonable. However, the High Court stated that, if swaps had been capable of being lawful, the transactions in the third period would have been reasonable and hence lawful.

Finally, the High Court noted, as to types of transactions, that swaps in which the Council was intermediating could never be regarded as part of debt management, nor could those in which the Council sold options or otherwise received premiums. If other types of swaps were capable of being lawful for interest rate management purposes, each would have to be looked at individually.

The effect on the banks and the marketplace was more complex. The High Court discussed three possibilities regarding their decision that the swaps should not be included in the accounts, being contrary to law:

- the contract is void and gives no private law rights to the parties;
- the contract is 'improper' in the sense that a public body should not have entered it, but it gives rise to private law rights; and
- the contract is proper although the source of payment is improper.

In the first case, the contracts would be unenforceable. In the second and third cases, the contracts might be enforceable under private law, by analogy to the law applicable to companies, as long as the banks neither knew nor ought to have known of the defect. The High Court stated that the law applicable to companies would probably not apply to public bodies, but recognised the force of these arguments. Since the High Court had found that swaps could never be lawful, the issue did not properly arise and the court refrained from passing on it.

The decision touched upon, but did not definitively decide, the position of the banks. The quandary in which they found themselves was: should they treat the swaps as unenforceable and go into the market to cover, in which case a subsequent decision on appeal that the swaps were enforceable could leave them exposed on the replacement swaps; should they treat the Council as in breach, terminate the swaps, cover in the marketplace and claim for damages; or should they appeal, continue to treat the swaps as enforceable and not cover, in which case they would be exposed to the possibility of increased future losses?

### Court of Appeal

13.5 The banks appealed the decision. The Court of Appeal held that, as part of its powers to borrow money and to manage debt and investments, a local authority could have the power to enter into swap instruments but that most of the Council's swaps were unlawful because the Council entered into them for an improper purpose.

The Court of Appeal evidenced a substantially more commercial and realistic view of the economic factors underlying swaps, their relation to prudent management of risk within an institution and their emergence as an integral part of modern financings than had the High Court. The Court of Appeal emphasised the commercial nature of swaps, noting that swaps were a form of insurance but hastening to add '(in effect, but not of course in law)'. The court also distinguished swaps from gaming contracts, perhaps prompted by the sensational references to swaps as gambling found in segments of the tabloid press:

'If A and B, independently of any other transaction, agree to make payment one to the other depending on the market value of one currency in relation to another on a specified date in the future, they are wagering. But if a banker who has agreed to sell foreign currency to a customer at a future date at its then market value makes a back-to-back purchase contract, he is simply ensuring that he cannot lose. In the interest rate swap market, as in these others, the true commercial character of a transaction will become apparent only when the full circumstances of it are examined. If a transaction of this kind is not to be regarded as speculative trading, however, it must be made, by one party at least, with clear reference to an underlying obligation or asset.'

Turning to the Council's involvement in the swap market, the Court of Appeal noted that local authorities are permitted to borrow money. To protect themselves against interest rate fluctuations, they would be permitted to repay an existing loan and substitute for it a replacement loan on a different interest basis. Similarly they might agree to amend the borrowing agreement to vary the rate of interest. Swaps are:

'an economical and convenient method of achieving the same financial result as could have been achieved by repayment and replacement borrowing or by agreement with a lender without repayment of the loan. So expressed, swap transactions, entered into for such a purpose are a novel method of achieving an unexceptional end:

"regulating to best advantage the rate of interest payable on an authority's indebtedness."

Of course, entering into a swap transaction with reference to a particular debt does not have the effect in law of altering the rate of interest payable by the local authority as borrower to the lender. But, commercially, the combined effect of the original loan and the swap transaction is the same as if the interest rate in the actual loan had been varied.'

The High Court had disregarded these arguments, in large part because of the extensive detail in the relevant legislation relating to local authority borrowings and refinancings. The Court of Appeal, however, noted that detailed legislation was not necessarily exclusive. An express provision in the regula-

## ENFORCEMENT OF DERIVATIVES DOCUMENTATION

20.1 Given the massive volume of derivatives, there was until the middle of the 1990s remarkably little litigation involving interpretation of the financial and enforcement provisions of derivatives agreements in *general* and of the ISDA master agreement and prior ISDA forms in particular. That has changed. The results of the decisions are mixed. Some decisions in the OTC derivatives markets are well reasoned and arrive at the right result.<sup>1</sup> Some decisions are poorly reasoned but still arrive at the right result, with no harm being done.<sup>2</sup> Some decisions are poorly reasoned but arrive at the right result, although the poor reasoning may have a negative impact on the OTC derivatives markets.<sup>3</sup> Some decisions are poorly reasoned, arrive at the wrong result and have a negative impact on the OTC derivatives markets, but an optimist may find some benefit accruing to the markets through increased attention to critical issues.<sup>4</sup> Occasionally there is a decision that is poorly reasoned, arrives at the wrong result, has a negative impact on the OTC derivatives markets and has no redeeming merit.<sup>5</sup>

The most significant legal issue with respect to the enforcement of derivatives agreements may arise under the insolvency laws of a counterparty's jurisdiction. This issue and some important cases in relation to it are discussed in chapter 11. Other significant litigated issues have arisen under regulatory laws (see chapter 12) and in relation to capacity (see chapter 13), recharacterisation and structuring abuses (see chapter 10), set-off (see chapter 19), suitability/misrepresentation (see chapter 14), swaps entered into in connection with loans and CDOs (see chapter 22) and, more recently, mark-to-market credit support (see chapter 21). A number of other derivatives cases have dealt with broader issues such as contract formation, governing law and jurisdiction (see chapter 16 and chapter 17). This chapter will discuss interpretation by the courts of the financial definitions and principal enforcement provisions of standard derivatives documentation.

At the outset, two overview points are useful to bear in mind. First, strict interpretation may be preferable with respect to financial provisions in the definition booklets and a more flexible approach may be preferable with respect to the legal, trading and credit provisions of the ISDA master agreement. The reasons for the distinction are much the same as those mentioned in chapter 1, para 1.14, with respect to the relative needs for detail in drafting in the two types of provision.

In analysing the financial provisions, a court might well prefer an approach of strict interpretation, particularly where the provisions have been drafted on an industry-wide basis and are between sophisticated institutions. The key to interpretation here is certainty, and not fairness or flexibility. Three situations might, however, require refinement of the application of that thought. Two are based on the unfortunate reality that traders may not always be as conversant with the definition booklets as would optimally be expected. They may use deal expressions not precisely falling within the definition booklets. In this case, presumably a court would look to market practice and the prior dealings between the parties. At least one dealer had a provision to this effect in its schedule to the ISDA master agreement. Further, where there are uncertainties within a definition, traders in different departments of the same dealer may have a different understanding of what it means. For instance, with respect to the definition 'not contingent' in the 1999 credit definitions as originally drafted (see chapter 6, para 6.24), the equity trading desks of two institutions might well have entered into a credit derivative assuming that the characteristic included convertible bonds exercisable only at the option of the holder, and priced it accordingly. The credit trading desks of the two institutions may have entered into a credit derivative assuming that the characteristic excluded such convertibles, and priced it differently. These are different derivatives markets with different conventions.<sup>6</sup> The words may be the same, but the intent of the parties at the date of contract formation may be different. A final qualification is that certain provisions of the definition booklets, particularly those relating to fallbacks and many of the standard credit derivatives provisions, deal with unexpected occurrences and uncertain future disruptions. These will inescapably be in a 'broad brush' form, lacking the precise detail that the ongoing payment provisions require.

A court may take a more flexible view on the requirement for certainty and precision in the ISDA master agreement than it takes with respect to the definition booklets. The long-term relationship (in the case of the ISDA master agreement, theoretically of an infinite duration since there is no external time limit in it) may also mean that precision in documenting the relationship would result in far too many pages. It is simply impossible to predict and draft for all potential future credit-related occurrences. In addition, precision may not be as uniformly desirable in this context as with respect to the financial provisions since a degree of flexibility and judgment may prove to be useful in the future on credit-related issues.

When dealing with clauses that are not immediately obvious, one has to consider the context and the purpose of it. There is nothing wrong in resolving ambiguities according to the specific context and purpose. When interpreting a standard market contract including standard market definitions, however, are we seeking to determine the intent of the parties, the draftsmen, the current G15 dealers, the regulators, or some combination? Further, a given word or expression does not always have to have the same meaning at all times and all contexts. That is one of the great attributes of the English language, even if a source of frustration to lawyers and judges.

This leads to the second point. Judges will only be as good in analysing derivatives issues as the lawyers in front of them.<sup>7</sup> While application of common sense in resolving the crux of a dispute is as possible with derivatives as any other financial instrument, common sense is not always the best way to

get to the crux of a derivatives issue. A number of judges have done pretty well in doing that in the cases discussed throughout this book. Some have not.

- <sup>1</sup> *Deutsche Bank AG v Ambac Credit Products, LLC* 2005 US Dist LEXIS 177760 (motion for summary judgment); 2006 US Dist LEXIS 45322 (decision after trial).
- <sup>2</sup> See *Morgan Stanley UK Group v Puglisi* (Queen's Bench Division, Commercial Court, January 1998).
- <sup>3</sup> See *Australia and New Zealand Banking Group Ltd v Société Générale* [1999] 2 All ER (Comm) 625 and New Law Online 2990915802; Court of Appeal (unreported, see New Law Online 200022803) and *Peregrine Fixed Income Ltd (in liquidation) v Robinson Department Store Public Co Ltd* (Commercial Court, Claim No 2000-Folio 277).
- <sup>4</sup> See *Hazell v Hammersmith and Fulham London Borough Council* [1991] 1 All ER 545, [1992] 2 AC 1, [1991] 2 WLR 372, HL; *rvsg* [1990] 3 All ER 33, [1990] 2 QB 697, [1990] 2 WLR 17, 1083, DC and CA.
- <sup>5</sup> *Aon Financial Products and Aon Corporation v Société Générale* 00 Civ 5863 4 March 2005 (USDC SDNY); *Aon Financial Products and Aon Corporation v Société Générale* 00 Civ 5863 19 January 2006 (USDC SDNY), fortunately reversed, 476 F 3d 90 (2d Cir 2007).
- <sup>6</sup> Similarly, questions may arise as to the interpretation of the same clause or expression in different contexts. A given characteristic in the 1999 credit definitions may be used for both obligations and deliverable obligations (again see chapter 6). Would it be interpreted in the same manner for all purposes under all circumstances, given the different contexts? In *Citibank NA v Morgan Stanley & Co International plc*, 2010 U.S. Dist. LEXIS 47368 (SDNY), primarily discussed in chapter 22, para 22.22, the court determined that the definition of consent in section 14 of the ISDA master agreement applied to the use of the word "consent" in a CDS, a fact on which few people would have focused in advance.
- <sup>7</sup> It is not reasonable to expect that a derivatives lawyer is going to be a judge anytime soon, although Ed Murray is giving it a shot. There are many elements of the derivatives markets that are counter-intuitive. There is a marked inconsistency between the temperaments required by the two callings.

## DEAL DISPUTES

20.2 Most of the cases discussed in other chapters involved disputes between dealers and end-users. Reflecting perhaps the maturity of the derivatives market, there are an increasing number of disputes between dealers. This may also illustrate the harsher realities of the new competitive world. Where 25 years ago financial institutions were reticent to sue one another and, *in extremis*, disputes were settled through a conversation between the respective CEOs, today there is less reluctance to litigate. There has been a noticeable increase in dealers moving more quickly to litigation, foregoing the communication between anguished bank chairmen who were loath to approve a lawsuit against another bank. On the other hand, dealers tend generally, albeit informally, to isolate the issue in dispute (that is, not declare a default under the ISDA master agreement) and maintain trading relationships while battling the specific issue before the courts.

The disputes tend to be of three types: disputes between traders as to what was orally agreed; conflicts between the trade call and the written confirmation; and disputes over the meaning or interpretation of the financial terms agreed. If traders dispute their oral agreement, immediate recourse is made to the tapes that are customarily made. Surprisingly often, however, the tapes are unclear. If the dispute does not arise promptly, they may have been discarded or lost.<sup>1</sup> Different financial institutions have different policies with respect to retention of tapes. Institutions also have varying policies and procedures for record-keeping in relation to negotiations. In either case, each side will typically have access to the tapes and records of the other. That having been said, each

side's records, even the contemporaneous ones, are more apt (but not certain) to reflect its own retrospective views of events. Several courts have commented on the credibility of witnesses, as well as some of the pressures and difficulties faced by a court in sorting out where the truth lies.

The court in *The First National Bank of Chicago v Ackerley Communications Inc* 2001 US Dist LEXIS 20895 (SDNY, 2001), primarily discussed in chapter 17, para 17.12, said in a footnote:

'In this regard, I find the straightforward testimony of Selle [Ackerley] infinitely more believable than the hedged and cagey answers given by Lance [First Chicago] as to the chronology of events on June 22, 1994.'

'First Chicago's alleged damages expert, Anderson, was in reality no more than a fact witness, and more importantly, was wholly unbelievable. His insistence on speechifying from the witness stand rather than answering the questions asked discredited his testimony entirely.'

In *PT Dharmala Sakti Sejahtara (Dharmala) v Bankers Trust* (19 October 1995), Comm Court, QBD; and (1 December 1995), Comm Court, QBD, primarily discussed in chapter 14, para 14.8, the court said:

'The conclusion at which I have arrived is that Mr Hyun (BTC) was and is an honest man, who did not set out either deliberately or recklessly to mislead DSS or the court. He was no doubt an enthusiast, and capable of marketing the transactions which he helped devise with considerable skill and persuasiveness. That does not mean he acted dishonestly or improperly or that he in any way misrepresented their effect. Whether, in the course of marketing the transactions, he in fact made inadvertent misrepresentations is a matter which I will have to consider. It will also be necessary to bear in mind that he, like other witnesses, has been exposed over a period not just to simple failures and mistakes of memory but also to the hot-house effect of this litigation, with its demands to recall or reconstruct as oral evidence details which would otherwise probably be forgotten. I have had in that light to consider inter alia submissions that his account in evidence of his presentation of the proposed transactions at the important meetings of 19 January and 16 February 1994 was fuller in some respects than is likely to have been the actual case. Again, however, I have come to the conclusion that any points which may be made in this respect are not ones which go to Mr Hyun's honesty or integrity.

[The Dharmala witnesses] clearly did not and do not have Mr Hyun's knowledge or experience in the area of derivatives. The extent to which they nonetheless were, or held themselves out as being, "sophisticated" in that area is a matter of dispute which I shall consider below. The general conclusion which I have reached in relation to their evidence is that it must be approached with some reserve. There are occasions when it can be demonstrated that they have been prepared, in DSS's and quite possibly their own interests, to give an account of events on oath for which there can be seen to have been no possible basis. Their evidence has also changed or developed in some respects which throw some doubt on their reliability. At points they also invited me to accept that they acted with a naivete and a weakness in relation to Mr Hyun which I found unconvincing. Pre-eminent and expert in the field of derivatives as Mr Hyun is, Mr Thio is a senior and experienced figure who would not in ordinary circumstances allow himself to be overborn or drawn into transactions which he did not understand. He appeared to me in some embarrassment at certain points in seeking to explain his attitude at the time of the relevant discussions. Under cross-examination and in the light of the documentary material shown to him, I think that he found it increasingly difficult to resist a number of the propositions being put to him. During his first day's cross-examination and in his second day in the witness box, he made a

number of significant concessions. Likewise, it appeared to me that Mr Kong was at times inviting me to accept a degree of passivity and reliance on his part which was improbable in the case of someone who I would consider likely in most circumstances to be conscientiously analytical as well as generally cautious in his approach to commercial and financial propositions put to him for consideration on behalf of a company in the Dharmala group. He was in general less accepting in cross-examination of points put to him by counsel for the plaintiffs than was Mr Thio. Mr Isaacs invited me to prefer his evidence at those points to Mr Thio's. I am unable to accept this invitation.'

An Australian court<sup>2</sup> noted the difficulties in deconstructing complex discussions among technical experts, based on hazy memories clouded by bias:

'By 13 November 1997 Messrs Treacy and Murphy had negotiated many contracts. They negotiated in a friendly atmosphere and at arm's length. They trusted each other. Each set out to negotiate a deal which was in the interests of their employer.

They used jargon and shorthand in their oral and written communications which made sense to them. Often deals were concluded without the necessity of mentioning and spelling out particular terms. Their past trading did a lot of the talking and it was unnecessary to expressly mention a term. Particular terms were implicit in their negotiations.

For those unfamiliar with their language of negotiation, to make sense of what they said or wrote would be impossible.

The court in determining the issues relating to contract and construction must take into account the pattern of the trading between Messrs Treacy and Murphy. In doing this, the court places itself in the shoes of the two men to determine what they intended and what they meant. It is a barren exercise to focus on the words used by them and seek to determine what they meant based upon plain English. They had their own dictionary.

PP's counsel spent considerable time focusing on the words agreed to by the negotiators and based upon the ordinary use of the English language argued that what had been agreed either did not make sense, was ambiguous, uncertain or unworkable. Such an approach is not helpful and lacks commercial reality.

It overlooks the fact that commercial men seek to arrive at an agreement and will use their own language to effect it.

The disputed contracts were negotiated by non-lawyers and without the assistance of lawyers. In the end it is necessary to look at what the parties did based on their language as understood by them to determine on an objective basis what they intended.'

The Australian court also discussed the difficulty in analysing conflicting recollections of negotiators on both sides.

'The court must in assessing a witness take into account that in giving evidence the witness is not embarking upon a memory test unaided by documents to refresh the memory or by appropriate prompting. In the end, of course, it is a question of what memory a witness does have of the events. But also important are questions of truthfulness, accuracy, detail and demeanour, not to mention a motive for departing from, or distorting the truth. It is appropriate to test evidence based on plausibility or reasonableness in the circumstances.

The first observation I make is that each employee witness was aware of the issues and each was determined not to say anything which might prejudice his or her employer's case.

Secondly, some gave evidence which was slanted to assist the employer.

Thirdly, most guessed in respect of the events and circumstances.

The court also referred to the defects in memories in which both sides recollected events or persons present at meetings which were subsequently proven wrong by external evidence. Witnesses sticking to their positions when proven wrong indicated an issue as to truthfulness.<sup>2</sup>

The court emphasised the significance of enforcing the clear terms of the contract, but said:

'In carrying out the task of construction the court is not confined to the words of the agreement. Gone are the days when the court construed a contract in a vacuum.'

<sup>1</sup> See the discussion in chapter 17, para 17.23 of *Bear Stearns Bank plc v Forum Global Equity Ltd* [2007] EWHC 1576 (Comm).

<sup>2</sup> See *Powercor Australia Ltd v Pacific Power* [1999] VSC 110, BC9907547, primarily discussed in chapter 17, para 17.23.

## FINANCIAL PROVISIONS

20.3 Even where the agreed terms are not disputed, the interpretation of those terms may be. As the derivatives markets have expanded, there have been an increasing number of disputes over specific financial terms of transactions. As might be expected, these tend to be with respect to the less precise parts of the definitions (for example, fallback provisions) or the less precise types of definitions (credit derivatives).

Controversy with respect to particular ISDA definitional terms have been referred to in discussing those terms (see chapter 6 in particular). A number of recent English and New York law cases have dealt with disputes over financial terms, and discernible patterns are beginning to emerge.

### *Deutsche Bank v ANZ and Boom Time Holdings v Goldman Sachs*

20.4 Two English cases illustrate different approaches that may be taken by an English court. *Deutsche Bank AG v ANZ Banking Group Ltd* (28 May 1999, unreported), Commercial Division, HC, primarily discussed in chapter 6, para 6.18, sheds some positive light on the approach which the English courts may be expected to take with regard to interpreting the financial terms of a derivatives transaction. ANZ raised a number of defences which the court categorised as ranging 'from the wholly unarguable to the inventive which cannot stand analysis', a colourful description for a narrow range of arguments. One claim by ANZ was that the credit event had to be 'substantial, not technical'. With respect to this argument the court said:

'... such terms satisfy none of the criteria for implication in any contract, let alone one such as this between two banks operating in the derivatives market. In particular, I cannot conceive of any banker who would agree to matters of such imprecision.'

ANZ also claimed that the news report had clearly been published by Daiwa for self serving purposes and should therefore be disregarded. The court responded that 'if self serving information was to be excluded then the agreement should have said so'. The court said any such allegation was scandalous, as no reputable City of London institution would consider doing such a thing.<sup>1</sup> Further, where there is a chain of transactions, as in this and

many other credit derivatives, policing such a clause is impractical, and a court would be reluctant to create such a condition. The court said these arguments:

'... really amount to an attempt to rewrite the agreement ANZ made because they now wish they had made a better or even perhaps a more sensible agreement. But the fact is that they did not and the law is that rewriting the agreement they did make is not permissible.'

The significance of this case lies in the way in which the court strictly construed the contractual terms, but in the context of market realities.

On the other hand, the Court of Appeal, in *Boom Time Holdings Ltd v Goldman Sachs Intl* (unreported, LAWTEL, 6/2/98 Document No C86000112), did make some judicious additions to the written agreement to carry out what it determined to be the overall intent of the parties. Boom Time Holdings Ltd (BTH) purchased a barrier call option with a six-month term from Goldman Sachs for HK\$18,287,500. The option provided for European exercise, a strike price of HK\$4.40 per share on 35 million shares of Pearl Oriental Holdings Ltd and a 'knock-out' price of HK\$6.60 with a 'rebate' of HK\$2.20. The confirmation was subject to an English law OTC option master agreement, which contained definitions and terms applicable to the option, presumably in much the same manner as the ISDA definition booklets, but apparently representing Goldman Sachs's version thereof. These definitions provided that if the price of the underlying shares reached the knock-out level (HK\$6.60) during the term of the option, the option would terminate and Goldman Sachs would pay to BTH the rebate (HK\$2.20) times the number of unexercised shares. The definitions also provided for adjustments on the occurrence of certain corporate events, including stock splits, stock dividends and the like. The calculation agent (Goldman Sachs) would, on the required date, adjust the exercise price and number of shares 'as it determines in good faith is necessary to preserve the economic equivalent of the obligations'. There was a series of methods to follow, failing the availability of which the parties would need to agree or, failing agreement, the parties would select a third party calculation agent.

Prior to the exercise date of 8 May 1996, Pearl announced a 'bonus issue' of two shares for one, conditional on shareholder and governmental approval. The bonus shares would go to holders of record as of 16 April, and the register of members was closed between 17 April and 23 April. 16 April was treated as the 'ex-date' by the Hong Kong Stock Exchange, where Pearl's shares were traded. From 16 April, the existing shares would therefore trade free of the right to receive shares, but the new shares would not trade until issued on 1 May. On 16 April, the existing shares traded at HK\$2.20.

Following a conversation between Goldman Sachs and BTH, each sent (apparently) crossing faxes. Goldman Sachs increased the number of shares by three (to 105,000,000) reduced the strike price to a third (HK\$1.4667), reduced the rebate to a third (HK\$0.7373) and reduced the knock-out price to a third (HK\$2.20) with effect 16 April for the existing 35 million shares and with effect 1 May for the newly issued 70 million shares. Goldman Sachs's position was based on its need to be able to trade the shares to hedge its position; since the newly issued shares would not trade until 1 May, Goldman Sachs set that as the date from which the reduced knock-out price would apply



to them. The BTH fax was the same except it required the reduction in the knock-out level to HK\$2.20 for all shares on 16 April. BTH sent a further fax reiterating this last point.

On 16 April, the Pearl shares traded at HK\$2.20 and Goldman Sachs paid BTH HK\$25,665,500 (0.737 × 35,000,000 shares). The price did not hit that level on or after 1 May with respect to the newly issued shares. On 8 May, BTH exercised, without prejudice to its claim, at HK\$2.05 per share, and brought an action for HK\$10,500,000 being the difference between the rebate price, which it claimed it should have received on 16 April, and the cash settlement amount on 8 May.

The lower court (*Boom Time Holdings Ltd and Goldman Sachs*, 25 February 1997, Mr Justice Colman) found for the defendants. It held that there was no express provision in the contract which required or permitted *any* adjustment to the knock-out price or rebate. It not being express, the court would not read one in. To the extent that the parties had agreed to adjustments (such as number of shares and strike price), the contract would be amended. Since they had not agreed the terms of the knock-out price as to the remaining shares, BTH was not entitled to any amount in respect of a rebate in relation to them. The court went on to say, however, that one of Goldman Sachs's arguments was not persuasive:

'So far as the plaintiff purchasers were concerned, the availability of hedging facilities for the defendants was irrelevant. The plaintiffs were entitled to assume that upon the happening of a clause 2.1 event the defendants would adjust those terms covered by clause 2.1 by reference to and only to the terms of the contract between buyer and seller and to no extraneous events other than the corporate alterations affecting the underlying securities. If the corporate dispositions were such that the defendants were unable to protect themselves by hedging, that might expose them to greater risk, but unless the contract provided otherwise, it could not affect the determination of what amounted to 'economic equivalence' within clause 2.1, for it would be an extraneous event unprovided for by the contract. The defendants marketed an option contract which they had designed in order to obtain business from traders such as the plaintiffs. If the contract were so drafted that it did not expressly provide for all eventualities which might expose the defendants to the risk of market fluctuations, there is no reason why the court should be astute to spell out protective provisions from express terms which do not on the face of it provide such protection.'

The Court of Appeal reversed in favour of BTH (*Boom Time Holdings Ltd v Goldman Sachs Intl*, Court of Appeal (6 February 1998), Civil Division). In so doing, the Court of Appeal rejected the lower court's central holding that the knock-out price and rebate did not need to be adjusted. The court, probably rightly, said that it was necessary to adjust the knock-out price and rebate if the calculation agent was to preserve the economic equivalent of the obligations. This, the court said, must have been one of the elements bargained for in determining the premium. It did not directly address the argument as to the two effective dates for the new rebate, but did say that the adjustments had to be made effective on the 'Adjustment Date', which had to be 16 April. While going beyond the strict wording of the relevant provision, the court made a broad, and eminently reasonable, interpretation of the term 'economic equiva-

lent' and applied it in a reasonable fashion in the context of the transaction as a whole.

<sup>1</sup> The learned judge may have been out of touch with the current markets.

#### Nomura v CSFB

20.5 Another English case held that a security with an embedded option is not an obligation subject to a contingency (*Nomura International Plc v Credit Suisse First Boston International* [2002] EWHC 160 (Comm)). CSFB had sold protection in respect of Railtrack plc to Nomura in a physically-settled credit default swap incorporating the 1999 ISDA credit definitions. Railtrack's entry into administration constituted a credit event. Nomura, following satisfaction of the other conditions to settlement, delivered a notice of intended physical settlement indicating that it was to deliver against payment of the reference price Railtrack's 3.5% exchangeable bonds due 2009.

The parties had agreed that 'not contingent' was a required deliverable obligation characteristic. This meant that, according to the 1999 credit definitions, the deliverable obligation must fit within the following description:

'... any obligation (A) the payment or repayment of principal in respect of which is not in an amount determined by reference to any formula or index, or which is not subject to any contingency . . .'

The exchangeable bonds were subject to the right of the holder (or under certain circumstances a trustee acting on its behalf) to require the issuer to deliver shares of Railtrack Group, extinguishing the payment obligation.

The court appears to have disregarded most of the evidence, testimony and precedents supplied from both sides and made its own analysis:

'It is true that the words "repayment in respect of which is not subject to *any* contingency" are wide ones but I do not think a provision which operates in favour of a bondholder and is exercisable at his option can sensibly let alone commercially be described as a contingency to which the holder's right of repayment is subject. It is within the control of the bondholder and depends on no external decision or event. If he chooses to claim repayment he is entitled to it. In contrast a bond convertible at the option of the issuer is a real contingency affecting payment of the principal amount of the bond: real both because it depends on an event over which the bondholder has no control and because commercially it is at the very least likely to be operated to deprive the holder of payment in exchange for an asset of less value.'

The court addressed the trustee's rights in similar terms, and then concluded:

'The payment obligation under a bond is subject to a contingency when the holder may be deprived of the full benefit of it by some external event over which he has no control but not by a provision or provisions in the bond itself designed solely to protect his interests.'

The court made four fundamental errors. First, it misread the definition. The relevant language is '*any obligation (A) . . . which is not subject to a contingency*'. The court's reading, '*any obligation (A) the payment or repayment of principal in respect of which . . . is not subject to any contingency*' is not a possible reading if the rules of punctuation and grammar are followed.

Secondly, the court applied the test of contingency to the *right* of the holder, not to the *obligation* of the issuer, as the definition itself unambiguously reads. One might conclude that the 'right' of one party and the 'obligation' of the other are usually the same. There are situations, however, like that before the court, where the different perspective may make a difference. When in doubt, the court should have followed the language in the definition.

Thirdly, the court unnecessarily, and in the context of the financial markets uncommercially, limited the concept of contingency to control over exercise. The holder of an option always has control over exercise. The holder does not have control over *profitability* of exercise; a holder does not exercise if he is going to lose money by doing so. In the world of modern finance, that is viewed as a contingency.

Perhaps the court did not follow the precise language because it missed the commercial rationale of the characteristic and supplied its own instead. The court, and this is the fourth error, seems to have assumed that the *sole* purpose of the clause was to require delivery of an obligation where the payment of principal could not be avoided by external factors:

'The purpose of requiring that the Deliverable Obligation be "Not Contingent" is, I think, plainly to secure a right to payment of the principal amount as such which cannot be affected in amount by extraneous factors over which the seller of credit, as holder, has no control.'

This was perhaps a mistake based on the court's misreading of the relevant definition referred to above and its unnecessary and uncommercial restrictive analysis of what a contingency is. Perhaps the court focused too closely on the extracted words in dispute without considering the meaning of the whole clause or the significance of pricing credit risk in the credit derivatives market.

Deliverable obligation characteristics (other than those which deal with mechanics of delivery) in fact relate to elements of debt which may generally be expected to affect its value independent of the market's view of the issuer's creditworthiness.<sup>1</sup> The definition as a whole reduces the risk of the end-using protection seller that it will be required to purchase at par an obligation the value of which is impaired, not only by reason of the deteriorating credit of the reference entity, but by reason of structural elements. The 'sole' purpose cited by the court is only one element of this broader use.

Most would concur that an option is a contingency, regardless of whether viewed from the writer's or seller's perspective. Most would concur that a 'vanilla' convertible/exchangeable bond contained an embedded option.<sup>2</sup> The embedded option may distort the price of the bond in several ways. First, the holder typically has a valuable right, for which it pays by receiving a reduced coupon, as the court noted but then disregarded.<sup>3</sup> Secondly, in a distressed situation short of bankruptcy and all debt being due and payable, the option is essentially worthless<sup>4</sup> but the coupon will still have value. Since the coupon on the convertible will be lower by reason of the originally issued option, it will trade more cheaply than the straight debt. While this is a result of the declining credit worthiness of the issuer, it is a leveraged result, which is precisely the sort of thing that the definition was intended to exclude. To avoid going into such analyses on delivery, the definition in a general way excludes obligations subject to a contingency.

The court recognised the pricing disparities between Railtrack's exchangeable debt and straight debt but misconstrued its significance. It was not a dispositive issue in the case, but it was illustrative of why the definition is there. The court further minimised its significance by making an essentially meaningless reference to line drawing and a discussion of other types of peripheral contingency. It seems not to have occurred to the court simply and rationally to draw the line at structural financial terms. The court further said:

'In all probability the "Credit Event" itself will reflect and crystallise the lack of benefit to be derived from the exchange right and the fact that the holder chooses to deliver the bonds will reflect the commercial reality that they are worth less than the obligation of the protection seller. That, after all, is what the buyer has bought: protection against the credit risk of the issuer.'

The court missed the point that the buyer was not, at least as known to the seller, also seeking to make a turn on the decline in value of the embedded option. In particular deals, when a specific convertible was *intended* to be delivered, dealers typically specified it as a reference obligation *and* selected 'not contingent' to exclude other contingent debt.<sup>5</sup> The court got this backwards, saying:

'What may be of minor significance (in addition to the pricing to which I have referred) is that I think it is clear that there were known uncertainties at the time about the ISDA Definitions, including 'Not Contingent', and that CSFB had devised a wording which would, if used, have removed any doubts that vanilla convertibles were "Not Contingent" and so were Deliverable Obligations. But the evidence does not establish any uniform market practice or understanding and Mr Gupta (a Managing Director of CSFB) readily accepted that as a matter of commercial practice in his opinion vanilla convertibles should satisfy the "Not Contingent" definition albeit he said CSFB did not believe that they did at the time. In substance it was always open to the parties to such a transaction to put the matter beyond doubt either way but the fact that they did not do so in this case does not advance the resolution of the Construction Issue.'

This case is an unfortunate example of a court narrowly reading (indeed misreading) a portion of a clause, missing its broader meaning and arriving at a poor decision. The English judiciary will, however, get off the hook on this one because the end result was the one desired by the dealing community for reasons not even mentioned in the opinion: increased liquidity. This decision, while inexplicable based on a literal reading or an understanding of the commercial rationale underlying the definition when written, pleased a large segment of the market by expanding the range of deliverable obligations and thereby expanding liquidity in the market.<sup>6</sup> It was not necessarily good news for end-using sellers of protection.

<sup>1</sup> The fact that market definitions and market practice have moved away from this concept should not retrospectively affect interpretation of standard terms drawn up four years ago which were applied and priced into transactions before the change in dealer preferences.

<sup>2</sup> 'Contracts that do not in their entirety meet the definition of a derivative instrument (refer to paragraphs 6-9), such as bonds, insurance policies, and leases, may contain "embedded" derivative instruments - implicit or explicit terms that affect some or all of the cash flows or the value of other exchanges required by the contract in a manner similar to a derivative instrument. The effect of embedding a derivative instrument in another type of contract ("the host contract") is that some or all of the cash flows or other exchanges that otherwise would be required by the contract, whether unconditional or contingent upon the occurrence of a specified event, will be modified based on one or more underlyings.' FASB 133.

<sup>3</sup> In this connection, the court could only say:

'There is also evidence that the value of that right may well be reflected in the price of Exchangeable Bonds and the interest coupon. The coupon on the Exchangeable Bonds was in fact less than on the Non-Exchangeable Bonds [bonds with a similar maturity but no exchange right]. On the other hand many other considerations may be relevant to the price and I do not think price is a significant factor in addressing the Construction Issue. If it were it could have been referred to as such. The only requirement as regards interest was stated in Section 2.18(b)(vii) itself namely that it should be payable but not at any specific rate.'

<sup>4</sup> The court said:

'Moreover it must have been in the contemplation of Nomura and CSFB that a Credit Event in respect of Railtrack plc such as to trigger the Confirmation would in reality operate so that at the time of delivery of Exchangeable Bonds to CSFB the exchange right would have been rendered commercially otiose. The right is only valuable in a context other than the context in which the buyer of credit protection is entitled to and claims the benefit of the protection he has bought.'

<sup>5</sup> A not de minimis part of the credit derivatives market consists of selling protection to hedge funds which buy convertibles, buy protection under credit default swaps, thereby eliminating the credit risk of the issuer, and sell options on the relevant shares. This can be viewed as stripping the options out of the convertibles. The profitability of the process is based on the fact that the bond market 'under-prices' the typical convertible in comparison to the aggregate of the market value of the share option and the value of the straight debt component calculated separately. The fund arbitrages the bond market, the equity share option market and the credit derivatives market. See chapter 5, para 5.12. This decision pleased those dealers who had sold protection to hedge funds which were arbitraging the equity option embedded in the exchangeable bonds. These transactions were typically *modified* from the standard to permit a specified convertible bond to be delivered while excluding other contingent instruments through the 'Not Contingent' characteristic. Some dealers, accepting a mismatch, then bought cheaper protection in the market without the ability to deliver the convertible. They made an immediate mark-to-market profit.

<sup>6</sup> As noted in chapter 6, para 6.24 the definition of 'not contingent' was substantially revised in the 2003 ISDA credit derivatives definitions to exclude only those obligations where payment of principal is subject to reduction.

## Eternity

20.6 The New York courts, or more properly, the US federal courts sitting in New York, have also examined the provisions of the 1999 credit derivatives definitions. A series of federal decisions applying New York law, in a seemingly never ending dispute, illustrate the approach of the US courts to interpreting the financial provisions of financial agreements, again involving the 1999 credit definitions.

The plaintiff, Eternity Global Master Fund Limited, was a hedge fund the purpose of which was to achieve 'capital appreciation while minimising Argentine portfolio volatility through hedging technology'. It purchased Argentine government bonds from Morgan Guaranty Trust Company of New York and hedged the credit risk with three credit default swaps in October 2001. The credit default swaps incorporated the 1999 credit definitions and were subject to an ISDA master agreement. Argentina was the reference entity, 'obligations' consisted of its debt and there were four credit events, including repudiation/moratorium and restructuring.

On 1 November 2001, Argentina's president issued a decree pursuant to which the Ministry of Economy was authorised to offer a voluntary exchange of Argentine debt. On 2 November, Eternity 'notified Morgan that it wanted to unwind'. This presumably meant that it wanted to be bought out of its

positions for value either by negotiating a termination of the transactions or by transferring its positions to a third party. Morgan apparently refused to quote any secondary market prices, although it offered to terminate and return the last month's premium. On 8 November, Eternity served a credit event notice, citing Argentina's rapidly deteriorating financial condition and the 'restructuring' announcements by the president. Morgan responded in a notice stating that the announced debt exchange did not constitute a credit event.

On 19 November, Argentina officially announced a voluntary debt exchange. On 28 November, the Ministry of Economy issued a decree setting out the details pursuant to which sovereign debt-holders could exchange their debt for secured loan instruments with lower interest rates and longer maturities. The tendered debt was to be released from a trust on any subsequent default by Argentina.<sup>1</sup> On 30 November, Eternity delivered a credit event notice stating that Argentina's 'restructuring' constituted a credit event. Morgan again responded on 3 December that no credit event had occurred. Eternity again demanded settlement on 12 December and Morgan replied on 14 December, for a third time, that no credit event had occurred.

On 24 December, Argentina announced it was suspending debt payments. On 27 December, Morgan delivered a credit event notice with respect to the repudiation/moratorium credit event as to two of the transactions, presumably on the basis of the 24 December announcement. The two transactions were settled without a waiver of Eternity's rights on the third.<sup>2</sup> Eternity sued.

Eternity raised three principal claims: breach of contract, common law fraud and negligent misrepresentation.<sup>3</sup> In adjudicating a motion to dismiss, the district court said that it 'must read the complaint generously accepting the truth of and drawing all reasonable inferences from well-pleaded factual allegations' and granted Morgan's motion to dismiss the latter two claims, with leave for Eternity to amend, but permitted the claim for breach of contract to stand as it was (*Eternity Global Master Fund Ltd v Morgan Guaranty Trust Company of New York and JP Morgan Chase Bank* 2002 US Dist Lexis 20706 (SDNY, 29 October 2002) ('*Eternity I*')); Morgan's motion to reconsider and to dismiss *denied* 2003 US Dist LEXIS 1834 (SDNY)). Eternity amended its complaint twice but, on a further motion by Morgan, the district court reversed its earlier position and dismissed the complaint (*Eternity Global Master Fund Ltd v Morgan Guaranty Trust Company of New York and JP Morgan Chase Bank* 2003 US Dist LEXIS 12351 (SDNY) ('*Eternity II*')). Eternity appealed, and the court of appeals affirmed the dismissal of the fraud and misrepresentation claims but reversed the dismissal of the breach of contract claim, requiring further examination of ambiguities in the definition of restructuring in the 1999 credit definitions (*Eternity Global Master Fund Ltd v Morgan Guaranty Trust Company of New York and JP Morgan Chase Bank* 2004 US App LEXIS 14222 (2d Cir) ('*Eternity III*')).<sup>4</sup>

The claim that Morgan breached the contract hinged on whether or not the voluntary Argentine debt exchange constituted a restructuring credit event under the 1999 ISDA credit derivatives definitions; if it did, Morgan should have settled in early December. The definition of restructuring in Section 4.7 of the 1999 credit definitions is:

- (a) "Restructuring" means that, with respect to one or more obligations, including as a result of an Obligation Exchange . . . any one or more of