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An Overview of Derivatives Litigation, 1994 to 2000

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AN OVERVIEW OF DERIVATIVES LITIGATION, 1994 TO 2000

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I. INTRODUCTION

Derivatives are financial instruments whose value depends on the value of an underlying asset price, reference rate, or index.[1]

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Mr. Finnerty has spent his career in the financial services industry having previously worked for Morgan Stanley, Lazard Frères, McFarland Dewey, Houlihan Lokey Howard & Zukin, and most recently, as a Partner in the PricewaterhouseCoopers Financial Advisory Services Group's Dispute Analysis & Investigations practice. He is a nationally recognized expert in securities valuation and has published extensively in that area, including nine books and more than sixty articles and professional papers. His most recent books include CORPORATE FINANCIAL MANAGEMENT and PRINCIPLES OF FINANCIAL MANAGEMENT, published by Prentice Hall, and DEBT MANAGEMENT, published by the Oxford University Press in fall 2001.

For the past fourteen years, Mr. Finnerty has also served as Professor of Finance at Fordham University. Mr. Finnerty received his Ph.D. in Operations Research from the Naval Postgraduate School, an M.A. in Economics from Cambridge University, which he attended as a Marshall Scholar, and a B.A. in Mathematics from Williams College. Mr. Finnerty is also an Editor of *FMA Online*, a former Editor of *Financial Management*, and a member of the editorial boards of three other financial publications.

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The primary purpose behind investing in derivative instruments is to enable individual or corporate investors to either increase their exposure to certain specified risks in the hope that they will earn returns more than adequate to compensate them for bearing these added risks (referred to as speculation) or reduce their exposure to specific financial risks by transferring these risks to other parties who are willing to bear them at lower cost (referred to as hedging). Due to a combination of market volatility and lack of sophistication, many derivatives users have failed to realize the financial outcomes they were seeking, and in some cases investors have suffered large losses and initiated litigation seeking to recover these losses.

This Article provides an overview of federal derivatives lawsuits filed and regulatory enforcement actions taken in the United States between 1994 and 2000. It summarizes the types and numbers of cases initiated and illustrates the trends that have become apparent. Also, a number of specific cases are discussed to highlight some of the important issues pertaining to derivatives litigation.

II. DERIVATIVES AND MARKET VOLATILITY

Derivatives litigation tends to increase following periods of heightened market volatility. This is because market volatility leads to greater movements in commodity prices, mortgage rates and interest rates, which in turn lead to greater changes in the value of derivative instruments. The largest number of derivatives cases was filed in 1994, following a period in which interest rates rose suddenly and dramatically.[2]

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focus on litigation. He has been with PricewaterhouseCoopers since 1999 and was admitted to the New York Bar in July 2000.

1. JOHN FINNERTY, THE PRICEWATERHOUSECOOPERS CREDIT DERIVATIVES PRIMER 3 (1999), *available at* http://www.creditex.com/creditex/content/pdf/pwc_CredDeri.pdf (last visited Jan. 14, 2002).

2. The interest rate for the 10-year Treasury note increased from 5.6% in January 1994 to 7.9% in November 1994. *See* BLOOMBERG BUS. NEWS, *Bonds Fall Again to Yield 8.03% on Surging Consumer Confidence*, INV. BUS. DAILY, Nov. 30, 1994, at B10 (stating that the ten-year treasury note was yielding 7.93%);

Investors who fail to appreciate the risks involved in using derivatives are often quick to seek legal redress against the financial institutions and brokerage houses that sold them. Common causes of action include securities fraud,[3] negligent misrepresentation,[4] and breach of fiduciary duty.[5] Consequently, derivatives dealers and their counsel can learn valuable lessons concerning the forms of behavior that will expose them to significant legal risks by reviewing the cases that have been filed and the judicial decisions that have been rendered.

III. OVERVIEW OF CASES FILED BETWEEN 1994 AND 2000

Information was gathered concerning federal court actions, federal enforcement actions, and to the extent it could be found, information concerning state-filed actions and arbitration proceedings in which at least one of the main allegations concerned futures or forward contracts, options, collateralized mortgage obligations ("CMOs"), inverse floaters, repurchase obligations (repos), structured notes, swaps, or other derivative instruments. Futures, forwards, options, and swaps are the basic derivative instrument building blocks.[6] These instruments are often combined in various packages to create more complex derivatives. CMOs, for example, are complex mortgage derivatives; inverse

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William Pesek Jr., *Lacking Retail Interest, Sullen Markets Fail to Crack Current Ranges,* BOND BUYER, Jan. 28, 1994, at 2 (stating that the ten-year treasury note was yielding 5.66% in January 1994).

3. Fraud in connection with the sale of securities pursuant to Section 10(b) and Rule 10b-5 of the Securities Exchange Act of 1934. *See, e.g.*, Laser Mortgage Mgmt., Inc. v. Asset Securitization, No. 00-CIV-8100, 2001 U.S. Dist. LEXIS 13746 (S.D.N.Y. Sept. 2000).

4. Where the defendants misstate or omit material facts "necessary in order to make the statements, in the light of the circumstances under which they were made, not misleading." 15 U.S.C. § 771(a)(2) (2000). *See, e.g.*, Laser Mortgage Mgmt., 2001 U.S. Dist. LEXIS 13746 (providing an example of a derivatives case with an allegation of negligent misrepresentation).

5. *See, e.g.*, Amada Co. Ltd. v. Republic N.Y., No. 99-CIV-11602 (S.D.N.Y. filed Nov. 29, 1999). The specific allegation involved the Defendant allegedly failing to segregate funds placed in its custody by the Plaintiff. *See $123 Million Suit Pending Grand Jury Action*, DERIVATIVES LITIG. REP., MAY 15, 2000, at 3.

6. *See* CHARLES W. SMITHSON ET AL., MANAGING FINANCIAL RISK (1995).

floaters are interest-rate derivatives; and structured notes are packages consisting of conventional notes and derivatives. All three usually contain interest-rate or currency options. Repurchase agreements are included in this study because the repurchase leg of the transaction is very similar to a forward contract for the underlying bond.

A. Frequency of Litigation and Enforcement Actions

Between January 1994 and December 2000, a total of 367 derivatives-related court cases and enforcement actions were filed in the United States.[7] Federal court actions have decreased somewhat, from a high of thirty-four cases in 1994 to twenty-four in 2000. Similarly, the number of federal enforcement actions has dropped from the steady mid-twenties for the prior three years to eighteen in 2000. Over the seven-year period, on average, twenty-five federal court actions and twenty-two enforcement actions were filed each year. Other cases include state-filed actions and arbitration cases. The figures in Exhibit 1 probably underestimate the numbers of cases in this category because such information is more fragmented than information regarding federal court and regulatory actions.

Jurisdiction	1994	1995	1996	1997	1998	1999	2000	Total Cases
Federal Court	34	27	32	15	21	22	24	175
Fed. Enforcement Actions	27	18	14	23	26	28	18	154
Other	5	11	10	2	2	6	2	38
Total Cases	66	56	56	40	49	56	44	367

Exhibit 1: Total Cases Filed Between 1994 and 2000.

B. Cases by Derivative Instrument Type

Futures and forwards have been the most common types of instruments involved in derivatives litigation since 1994, accounting for 29% of the cases filed. Options rank second and account for

7. *See infra* Exhibit 1 p. 134.

23% of the total cases filed during the period.[8] The number of cases involving CMOs has fallen from a high of twenty-one cases in 1995, just after the spike in interest rates in 1994,[9] to a figure in the single digits the past four years.[10]

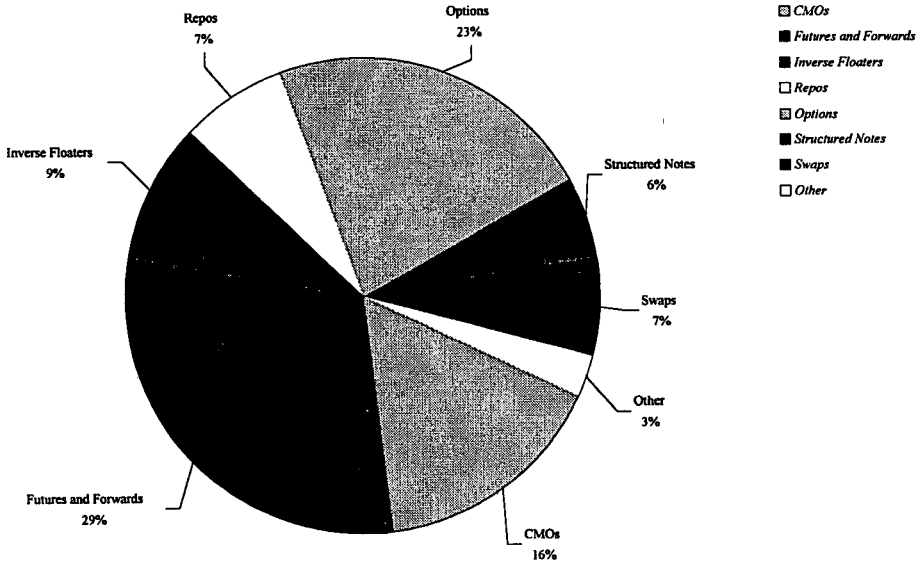

Exhibit 2: Percentage of Cases According to Type of Derivative Instrument - 1994 through 2000.

8. *See infra* Exhibit 2 p. 135.
9. *See infra* Exhibit 3 p. 136.
10. *See infra* Exhibit 4 p. 137.

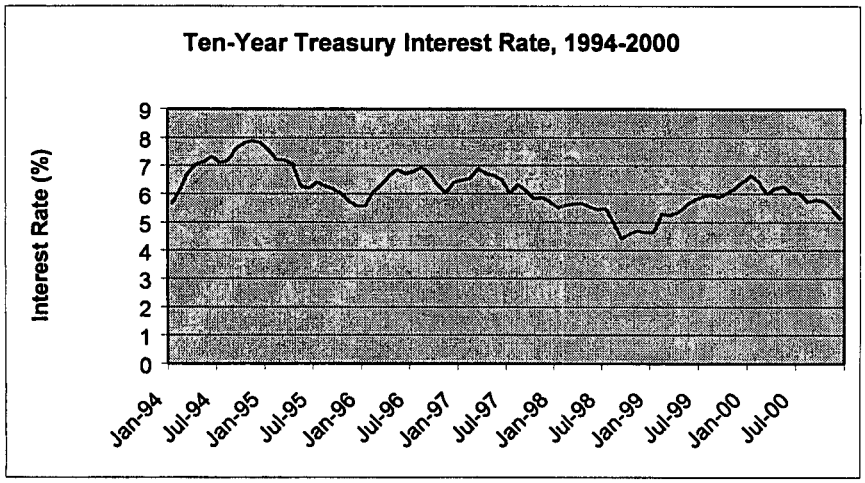

Exhibit 3: Interest Rate for 10-year Treasury Note, 1994 through 2000.[11]

In 2000, options were the derivative instrument most often involved in newly filed litigation, accounting for nineteen of the fifty-seven derivative instruments cited in the cases.

C. Credit Derivative Cases

Two of the cases filed in 2000 involve credit default swaps. A credit default swap functions like a letter of credit, enabling an investor to insure against an event of default, a bond rating downgrade, or some other specified credit event.[12] They are relatively new, and the market for them is expanding rapidly. These derivative instruments are difficult to value because the

11. *See generally,* Yahoo Finance, *at* http://quote.yahoo.com/q?s=^TNX&d=c&t=my&l=on&z=b&q=l (last visited Jan. 15, 2002) (providing the same general information contained in this table).

12. A credit default swap consists of an upfront payment, or series of payments, in exchange for the counterparty's obligation to make a payment that is contingent upon the occurrence of a specified credit event. *See* FINNERTY, *supra* note 1, at 15. It represents a form of credit insurance, which pays off when the credit event occurs. *See id.* On the fixed-payment leg of the swap, the buyer of credit event protection (the insured) agrees to make one or more payments, which represent insurance premiums. *See id.* On the contingent-payment leg of the swap, the seller of credit event protection (the insurer) agrees to make the specified contingent payment. *See id.*

underlying security is often not a traded instrument.[13] Until recently, standardized documentation was lacking, and many of the early disputes involving credit derivatives revolved around the threshold issue of whether a credit event, as defined in the documentation governing the instrument, had in fact occurred.[14]

Derivative Instrument	1994	1995	1996	1997	1998	1999	2000	Total Cases
CMOs[15]	19	21	14	7	7	3	7	78
Futures and Forwards	27	21	21	23	12	30	12	146
Inverse Floaters	9	7	12	4	7	0	7	46
Repos	7	4	13	5	4	0	2	35
Options	13	19	13	10	11	25	19	110
Structured Notes	3	1	7	4	5	5	2	27
Swaps	11	7	3	1	3	4	4	33
Other	1	0	0	0	5	3	4	13
Total	90	80	83	54	54	70	57	488[16]

Exhibit 4: Number of Cases According to Type of Derivative Instrument - 1994 through 2000.

D. Representative Credit Derivatives Cases

GMO Trust v. Credit Suisse First Boston[17] is a breach-of-

13. *Id.* at 41.

14. Examples of credit events include a bond default or a bond rating downgrade, which triggers a payoff under a credit swap. The event will be specified in the contract setting out the rights and obligations of each counterparty to the transaction. *Id.* at 46, 59.

15. CMOs include interest-only securities (IOs) and principal-only securities (POs). Dealers can take a portfolio of mortgages and decompose them into two classes of claims: IOs that receive all the interest payments and POs that receive all the principal payments. *See* ANDREA S. KRAMER, FINANCIAL PRODUCTS: TAXATION, REGULATION AND DESIGN § 2.1(B)(4) (1991).

16. Individual cases may contain more than one derivative instrument or underlying item.

17. GMO Trust v. Credit Suisse First Boston, No. 00-CIV-3760 (S.D.N.Y. filed May 18, 2000). The complaint in this case was filed on May 18, 2000, and the parties agreed to a settlement on March 20, 2001. *See Mutual Fund Sues Credit Suisse First Boston For $4 Million,* ANDREWS' BANK & LENDER LIAB.

contract dispute involving two credit default swaps tied to Ecuadorian bonds with a notional value of $93.5 million.[18] The swap counterparties were GMO Fund ("GMO"), the buyer, and Credit Suisse First Boston ("CSFB"), the seller. As long as Ecuador made the payments due under the reference bonds, GMO was obligated to pay CSFB a fixed amount calculated on the basis of the accredited face value of the reference bonds.[19] In the event Ecuador committed a payment default, GMO would be entitled to receive a specified credit default payment from CSFB.[20] In March 2000, Ecuador defaulted on its payment obligations under the reference bonds.[21] As the "calculation agent" designated in the swap confirmations, CSFB was responsible for determining the market price of the reference bonds at termination and calculating the amount of the payment due GMO.

The lower the value of the reference bonds at the time of termination, the greater the payment GMO would receive and vice versa.[22] GMO thus desired the lowest valuation of the bonds

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LITIG. REP., June 29, 2000, at 4; *Two Derivatives Cases Settle in S.D.N.Y.*, ANDREWS' BANK & LENDER LIAB. LITIG. REP., June 1, 2001, at 8.

18. The principal amount, or face value, of a bond is the amount of money that the bond issuer promises to pay to the bondholder when the bond matures. *See* BARRON'S DICTIONARY OF FINANCE AND INVESTMENT TERMS 469 (5th ed. 1998). *See* RICHARD J. TEWELES & EDWARD S. BRADLEY, THE STOCK MARKET 44-46 (7th ed. 1998). The market value of the bond can be lower or higher than the principal amount, depending on prevailing interest rates, the time to maturity, and the creditworthiness of the bond issuer. *See id.* The notional value of the swap is usually tied to a specific principal amount of the underlying bond. *See generally* Charles W. Smithson & CIBC Wood Gundy, *A Building Block Approach to Financial Engineering: An Introduction to Forwards, Futures, Swaps and Options*, MIDLAND CORP. FIN. J., Winter 1987 (providing general definitions of swaps among other derivatives products). It is only a notional value because the swap is not a bond contract, and the notional value is used solely to calculate the amount of any payments due under the swap contract. *See id.*

19. The reference bonds in this case were bonds issued by the Republic of Ecuador. *See Mutual Fund Sues Credit Suisse First Boston For $4 Million, supra* note 17; *Two Derivatives Cases Settle in S.D.N.Y., supra* note 17.

20. The amount of this payment was to be based on the market value of the reference bonds at the time of the default. *See Mutual Fund Sues Credit Suisse First Boston For $4 Million, supra* note 17.

21. *Id.*

22. *See id.*

possible whereas CSFB sought the highest. The manner in which the market price was to be determined, as stipulated by the swap confirmations, required CSFB to poll five established market makers for their offer prices for the reference bonds and to use the average as the value of the reference bonds.[23] GMO accused CSFB of falsely inflating the market value of the reference bonds by manipulating the market makers.[24] CSFB denied the allegation and counterclaimed that GMO improperly pressured the market makers to quote lower offer prices.[25]

Aon Financial Products Inc. v. Societe Generale[26] is a breach-of-contract dispute involving two back-to-back credit default swaps that were intended to shift loan repayment risk as part of the construction financing for a condominium tower in the Philippines.[27] Bear Stearns International ("Bear Stearns") loaned $9.3 million to Ecobel Land, Inc. ("Ecobel"), a Filipino corporation.[28] As a condition precedent to the loan, Ecobel was required to procure a surety bond guaranteed by the Government of the Philippines and Bear Stearns as obligee.[29] The surety bond was the underlying reference asset upon which Bear Stearns and Aon Financial Products, Inc. ("Aon") entered into a credit default swap with the former as the credit default buyer and the latter as the credit default seller.[30] The credit default swap was designed to compensate Bear Stearns if Ecobel defaulted and the Philippines

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23. GMO Trust v. Credit Suisse First Boston, No. 00-CIV-3760 (S.D.N.Y. filed May 18, 2000), at 9.

24. The alleged manipulation included CSFB's initial failure to indicate to the market makers that there were three bonds in total, "asking for a single offer price for the entire $93.5 million would produce a higher price — one more favorable to CSFB and less favourable to the GMO Fund." *See id.* at 10-11; *see also Mutual Fund Sues Credit Suisse First Boston For $4 Million, supra* note 17.

25. *Two Derivatives Cases Settle in S.D.N.Y., supra* note 17.

26. Aon Financial Products Inc. v. Societe Generale, No. 00-CIV-5863 (S.D.N.Y. filed Aug. 8,2000); *see also* Ursa Minor Ltd. v. Aon Financial Products, No 00-CIV-2474, 2000 U.S. Dist. LEXIS 10166 (S.D.N.Y. Jul. 2000) (providing an example of a similar case).

27. *See Aon Financial Products*, No. 00-CIV-5863, at 4.

28. *See id.* at 2.

29. *See id.* at 4.

30. *See id.* at 3.

refused to pay under the surety bond.[31] Subsequently, Aon hedged its credit risk exposure under the swap with Bear Stearns by entering into a credit default swap agreement with Societe Generale,[32] a French banking institution, with the latter as seller. Ecobel allegedly defaulted on the Bear Stearns loan in March 2000.[33] However, a dispute ensued over whether a 'credit event' had actually occurred. The United States District Court ruled that a 'credit event', as defined by the original credit default swap agreement between Aon and Bear Stearns, had indeed occurred and that Aon was required to pay Bear Stearns.[34]

Nonetheless, Societe Generale has refused to pay Aon under their credit default swap, arguing that the credit event in their swap has not occurred.[35] Accordingly, Aon is suing Societe Generale for $10 million on two counts: indemnification and breach of contract.[36] Aon bases the former count on the fact that since both of the credit swaps it engaged in relied upon the same underlying documents and security, Societe Generale is obligated to reimburse Aon under its agreement to indemnify Aon for its credit default swap obligation to Bear Stearns.[37] The second count arises from Societe Generale's denial that a valid 'credit event' occurred.[38]

The Aon-Societe Generale dispute is one of many disputes that have developed because of the lack of a standard definition of 'credit event'. Since the International Swaps and Derivatives Association ("ISDA") developed its standard documentation for credit default swaps in 1999, including a definition of 'credit event', the potential for such disputes has diminished.[39] However, newly developed derivatives may be difficult to document properly with existing standard documentation, which exposes the parties to

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31. *See id.*
32. *See id.* at 1.
33. *See id.* at 4.
34. *See id.* at 7.
35. *See id.* at 8.
36. *See id.* at 7-8.
37. *See id.* at 7.
38. *See id.* at 8.
39. The ISDA is the global trade association representing leading participants in the privately negotiated derivatives industry. *See* ISDA, *at* www.isda.org (last visited Jan. 16, 2002).

documentation risk, which in turn can result in legal disputes over the meaning of nonstandard contract provisions.

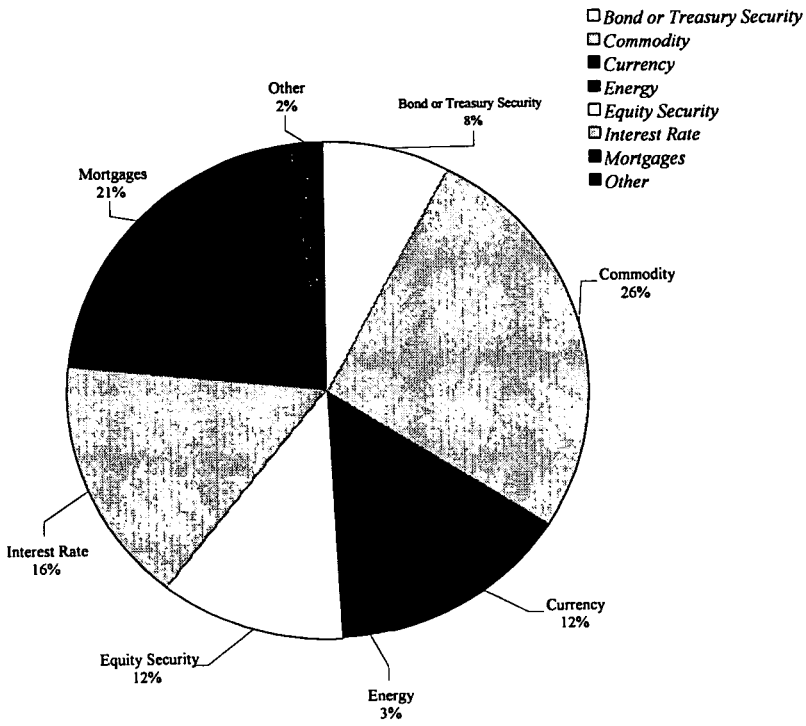

Exhibit 5: Percentage of Cases According to Underlying Asset Class - 1994 through 2000.

IV. CASES BY UNDERLYING ASSET CLASS

Commodities are the asset class underlying more derivatives cases than any other asset class involved in derivatives litigation filed between 1994 and 2000. Commodities accounted for 115 cases (26% of the total), though only nine cases involving commodities were filed in 2000.[40] Commodities have frequently been involved in consumer investment fraud cases.[41] Investment

40. *See infra* Exhibits 5 & 6, pp. 141-42.

41. *See, e.g.*, Commodity Futures Trading Comm'n vs. IBS, 113 F. Supp. 2d 830 (W.D.N.C. June 2000).

promoters often claim to have developed highly profitable proprietary trading strategies structured around commodity forwards, futures, and options, which often turn out to be nothing more than Ponzi schemes.[42]

Underlying Asset Class	1994	1995	1996	1997	1998	1999	2000	Total Cases
Bond or Treasury Security	7	4	6	2	3	7	6	35
Commodity	21	13	16	16	13	27	9	115
Currency	8	10	7	12	2	6	7	52
Energy	1	5	0	2	0	5	0	13
Equity Security	3	6	5	5	10	12	16	57
Interest Rate	20	11	14	7	10	4	5	71
Mortgages	20	22	20	8	11	3	9	93
Other	0	0	0	0	2	3	3	8
Total	80	71	68	52	51	67	55	444[43]

Exhibit 6: Number of Cases According to Underlying Asset Class - 1994 through 2000.

The number of mortgage-related cases has dropped from approximately twenty per year between 1994 and 1996 to an average of fewer than eight per year between 1997 and 2000. This drop can be attributed to interest rates generally declining and becoming less volatile beginning in 1997 following a period of highly volatile interest rates that extended from 1994 through 1996.[44]

The number of equity-securities-related cases rose from three in 1994 to sixteen in 2000. This increase in equity derivative lawsuits is at least partly the result of the increases in online

42. *See, e.g., Goldinger, Pairgain Charged Civilly and Criminally in Options Fraud Actions,* ANDREWS' SEC. LITIG. & REG. REP., Nov. 29, 2000, at 4 (discussing federal actions against S. Jay Goldinger, an investment adviser who allegedly used a Ponzi-like system to commingle funds and engage in a "massive securities-futures trading misallocation scheme."). The action against Goldinger was ultimately settled. *See SEC Settles Action Against Goldinger; Terms Not Disclosed,* ANDREWS' DERIVATIVES LITIG. REP., Mar. 6, 2000, at 6.

43. Individual cases may contain more than one derivative instrument or underlying item.

44. *See supra* Exhibit 3 p. 136.

trading activity and securities trading volumes.[45] The extraordinary volatility of Internet stocks will likely lead to an increase in litigation because of the precipitous decline in the prices of these stocks beginning in March 2000.[46]

A. Representative Cases

Cromer Finance, Ltd. v. Michael Berger[47] is an example of litigation stemming from the alleged misrepresentation of the performance of an Internet stock fund. This case is a securities class action brought on behalf of investors who purchased securities of a hedge fund that engaged in short-selling of securities of Internet and other high-tech companies.[48] Investors in the fund lost in excess of $400 million on the hedge fund's short selling, representing more than 90% of their investment.[49] The fraud was not detected by the two Big Five auditors, Deloitte & Touche and Ernst & Young LLP, who attested to the fund's operating results and financial condition.[50] In an April 2001 ruling, the claims were dismissed against some of the larger defendants, including Deloitte & Touche, but the action was set to proceed against the five smaller defendants.[51] In July 2001, the remaining defendants filed a motion to dismiss the Second Amended Complaint for failure to state a claim or to plead fraud with the required specificity.[52]

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45. The number of on-line traders increased from none in 1994 to six million in early 2000. *See* United States General Accounting Office, *On-Line Trading Better Investor Protection Information Needed on Brokers' Web Sites*, GAO/GGD-00-43, May 9, 2000.

46. The NASDAQ Composite Index fell from 4963 on March 24, 2000 to 2470 on December 29, 2000. *See* Jack Duffy, *U.S. Stock Funds Post Steepest Drop Since 1974: Mutual Funds,* BLOOMBERG NEWS, Dec. 21, 2001 (noting that between the NASDAQ's March 2000 peak and December 2001 the NASDAQ had plunged 66%).

47. Cromer Fin., Ltd. v. Berger, No. 00-CIV-2284, 2001 US Dist. LEXIS 21440 (S.D.N.Y. Dec. 2001).

48. *See id.* at *2-7.

49. *See id.*

50. *See id.*

51. *See* Cromer Fin., Ltd. v. Berger, 137 F. Supp. 2d 452 (S.D.N.Y. Apr. 2001).

52. *See* Respondent's Motion to Dismiss, Cromer Fin. Ltd. v. Berger, No. 00-

In *Log On America, Inc. v. Promethean Asset Management LLC.*,[53] the derivative instrument involved was "toxic" or "death spiral" convertible preferred stock.[54] Log On America, Inc. ("LOA") has alleged that Promethean Asset Management ("Promethean") and several other corporate investors used this type of convertible stock as part of a short-selling scheme that drove the company's stock price from $17 to $2.50 a share.[55] The security at issue is preferred stock that can be converted to common stock based on a floating conversion ratio.[56] The special feature of the so-called "death spiral" convertible stock is that the conversion formula is linked to the price of the common stock at the time of conversion. Therefore, if the stock price falls, the convertor receives a greater number of shares of common stock.[57] The conversion of preferred stock into common stock can thereby act to dilute the ownership interests of the other shareholders. Thus, the owner of the convertible preferred stock has a vested interest in seeing the price of the underlying common stock drop. In this case, Promethean and other convertible preferred owners sold short large quantities of common stock at prices lower than the current market price.[58] The short selling depressed the price of LOA's stock.[59] Promethean responded by claiming that it was acting within its contractual rights and that the agreement contemplated and authorized short sale transactions, which Promethean argues were intended to hedge its equity risk exposure.[60]

After LOA's share price had fallen dramatically, LOA refused

CIV-2498, 2001 U.S. Dist. LEXIS 14744 (S.D.N.Y. Sept. 2001).

53. Log On America, Inc. v. Promethean Asset Mgmt., No. 00-CIV-6218, 2001 U.S. Dist. LEXIS 20374 (S.D.N.Y. Dec. 2001).

54. The "toxic" or "death spiral" convertible stock has a conversion formula that is linked to the price of the common stock at the time of conversion. Therefore, the owner of the convertible preferred stock has a vested interest in seeing the price of the underlying common stock become temporarily depressed, thereby having a "toxic" effect on the stock price.

55. *Log On America, Inc.*, 2001 U.S. Dist. LEXIS 21440, at *2.

56. *Id.* at *2-12.

57. *See id.*

58. *See id.*

59. *See id.*

60. *See id* at *11-12.

to allow the preferred holders to convert their shares,[61] which triggered their suit for breach of contract. The Court must decide how to resolve the dispute over what is really a highly flawed and poorly written contract, which gives the preferred stockholders a financial incentive to drive down the issuer's stock price to the detriment of all the issuer's other common stockholders.

In *Dorchester Investors v. Peak International Ltd,*[62] the plaintiff alleges that Donaldson, Lufkin & Jenrette Securities ("DLJ") sold Trust Enhanced Dividend Securities ("TrENDS")[63] as a vehicle for repayment of a $55 million loan the brokerage firm made to the principal stockholder of British Virgin Islands-based Peak International, Inc.,[64] and along with Peak, failed to disclose in the prospectus arrangements that had been put in place allegedly to facilitate the short sales of the Peak stock.[65] The suit alleges that the defendants failed to disclose that DLJ sold the TrENDS to its hedge fund customers and loaned them Peak stock, knowing that the hedge funds would buy the TrENDS and short-sell the underlying Peak stock.[66] This arbitrage activity allegedly drove down the price of the Peak common stock, and ultimately, the TrENDS.[67] The suit involves the issue of whether the short selling went beyond what would be considered normal market-making activities by a securities dealer.

Other more exotic instruments that were the subject of litigation in 2000 include Liquid Yield Option Notes ("LYONs"),[68]

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61. *See id.*

62. Dorchester Investors v. Peak Int'l Ltd., 134 F. Supp. 2d 569 (S.D.N.Y. May 2001).

63. TrENDS are derivative instruments that derive their value from non-dividend-paying common stock based on the performance of that stock over a set period of time. *See generally, Hedge Fund 'Shorts' Eroded Derivative Stock and Damaged TrENDS, Suit Says*, BANK & LENDER LIABILITY LITIG. REP., July 21, 1999.

64. *Dorchester Investors*, 134 F. Supp. 2d at 571-76.

65. *See id.*

66. *See id.*

67. *See id.*

68. LYONS are zero-coupon convertible bonds with call and put options. *See generally*, Datek-Helpdesk Glossary, *at* http://www.datek.com/helpdesk/glossary/bfglosl.html (last visited Jan. 14, 2002).

bond investments,[69] non-deliverable forward currency contracts and total return swaps linked to Russian notes,[70] such as GKOs[71] (treasury bills) and OFZs (bonds).[72]

V. CASES BY DERIVATIVE INSTRUMENT'S MARKET

Derivatives traded over the counter ("OTC") accounted for 78%[73] of all cases filed between 1994 and 2000.[74] This situation is largely due to the fact that the vast majority of derivative instruments are traded in the OTC market. The OTC market permits greater customization of derivative instruments, which is useful to speculators who want to fine-tune their bets, and is also useful to hedgers who are seeking more cost-effective hedges than they can get from the options and futures exchanges. OTC trading is less regulated and tends to involve the more exotic and more volatile derivative instruments. Instruments traded on the NASDAQ and the Chicago Mercantile Exchange ("CME") were the next most likely to be the subject of litigation, involving nineteen and fourteen cases, respectively.

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69. *See* Gallagher v. SEC, No. 00-70141, 2001 U.S. App. LEXIS 25479 (9th Cir. Nov. 2001).

70. *The High Risk Opportunities Fund Ltd. v. Credit Lyonnais*, No. 00-Civ-600229 (N.Y. Sup. Ct. dated Jan. 19, 2000).

71. GKOs stand for *Gosudarstveniye Kratkosrochniye Obligatsii,* or short-term state obligations. *See* Catherine Belton, *Finance Ministry Wants Early GKO Bonds Issue*, ST. PETERSBERG TIMES, Feb. 11, 2000, *available at* www.sptimesrussia.com/secur/541/news/b_finans.htm?735curr (last visited Jan. 13, 2002).

72. OFZs stand for *Obligatsii Federal'nogo Zaima*, or three-year notes. *See* Catherine Belton, *Finance Ministry Wants Early GKO Bonds Issue*, ST. PETERSBERG TIMES, Feb. 11, 2000, *available at* www.sptimesrussia.com/secur/541/news/b_finans.htm?735curr (last visited Jan. 13, 2002).

73. This number is derived from 287 out of 367 cases.

74. *See infra* Exhibit 7 p. 147.

Market	1994	1995	1996	1997	1998	1999	2000	Total Cases
AMEX	0	1	0	1	0	2	1	5
CBOT[75]	2	0	5	1	0	3	0	11
CME[76]	1	3	4	4	0	2	0	14
MGE[77]	0	0	0	2	0	0	0	2
MidAm[78]	1	0	0	0	0	0	0	1
NASDAQ	3	0	6	1	7	2	0	19
NYSE	1	2	0	0	3	2	1	9
NYBOT[79]	1	0	0	0	0	3	1	5
NYMEX[80]	1	2	1	0	1	3	0	8
Non-U.S. Exchange	1	2	1	0	0	0	0	4
Philadelphia Stock Ex.	0	0	0	0	0	0	1	1
Pacific Stock Exchange	0	0	0	0	0	0	1	1
OTC	55	46	39	31	38	39	39	287
Total Cases	66	56	56	40	49	56	44	367

Exhibit 7: Number of Cases Filed According to the Derivative Instrument's Market - 1994 through 2000.

75. Chicago Board of Trade.
76. Chicago Mercantile Exchange.
77. Minneapolis Grain Exchange.
78. MidAmerica Commodity Exchange.
79. New York Board of Trade.
80. New York Mercantile Exchange.

VI. FEDERAL DERIVATIVES CASES BY CIRCUIT

The Second and Ninth Circuits, representing New York and California respectively, have handled the vast majority of derivatives cases filed since 1994.[81] The reason for the high number of cases filed in the Second Circuit is because New York serves as the financial capital of the United States. The relatively high number of cases for the Ninth Circuit, especially between 1994 and 1996, may be attributed to the large amount of litigation stemming from financial problems experienced by Orange County.[82]

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81. PRICEWATERHOUSECOOPERS DERIVATIVES LITIGATION STUDY 8, *available at* http://www.pwcderivatives.com (last visited Nov. 25, 2001).

82. Orange County in California was declared bankrupt in 1994 after suffering a loss of over $2 billion in derivative transactions. *See generally* Lyle Roberts, *Suitability Claims under Rule 10b-5: Are Public Entities Sophisticated Enough to Use Derivatives?,* 63 U. CHI. L. REV. 801 (1996) (discussing the Orange County bankruptcy in addition to financial problems of other public entities caused by derivative investments). An example of the litigation resulting from the Orange County debacle is *County of Orange v. Merrill Lynch & Co., Inc.*, in which it was alleged that the defendant assisted the former county treasurer in entering into illegal, unmatched reverse repurchase obligations on behalf of Orange County despite having the knowledge that such obligations were prohibited by law. *See* County of Orange v. Merrill Lynch & Co., Inc., 241 B.R. 212, 214-19 (Nov. 10, 1999). The former county treasurer allegedly used short-term funds borrowed through reverse repurchase agreements to acquire Swiss franc LIBOR two-year floating rate notes issued by the Student Loan Marketing Association, or Sallie Mae; this strategy represented a massive gamble that interest rates would not rise. *Id.* In February 1994, the market began to turn sharply against the treasurer's speculative strategy, resulting in Orange County's financial ruin. *Id.* Another example of the litigation resulting from the Orange County bankruptcy is County of Orange v. McGraw Hill Cos., Inc., 245 B.R. 151, 153-54 (Mar. 18, 1999), in which the Court denied McGraw Hill's motion for summary judgment on the plaintiff's breach of contract and professional claims, which alleged the defendant was liable for "providing rating analyses which wrongly stated that the County's financial condition and ability to repay the debt were fundamentally sound." *Id.; see also infra* Exhibit 8 p. 149.

Federal Circuit	1994	1995	1996	1997	1998	1999	2000	Total Cases
First Circuit	2	0	1	0	1	0	0	4
Second Circuit	10	13	8	5	7	6	18	67
Third Circuit	0	1	4	1	0	2	0	8
Fourth Circuit	2	1	0	1	2	1	2	9
Fifth Circuit	0	1	0	0	2	2	0	5
Sixth Circuit	5	2	1	0	0	0	0	8
Seventh Circuit	2	1	6	3	0	3	0	15
Eighth Circuit	2	1	1	2	0	0	0	6
Ninth Circuit	9	4	9	3	5	4	2	36
Tenth Circuit	2	0	0	0	1	2	0	5
Eleventh Circuit	0	3	2	0	3	2	2	12
Total Cases	34	27	32	15	21	22	24	175

Exhibit 8: Number of Cases Filed According to Federal Circuit - 1994 through 2000.

VII. FEDERAL ENFORCEMENT ACTIONS

Over 70%[83] of the federal enforcement actions initiated between 1994 and 2000 were filed by the Commodity Futures Trading Commission ("CFTC"), the regulatory body governing commodity trading. One hundred and ten cases were filed by the CFTC compared to thirty-eight by the Securities and Exchange Commission ("SEC") over the 1994 through 2000 period. Only six cases were brought by the Department of Labor ("DOL") in their capacity as regulator of public and private retirement plans. The DOL cases generally involve the allegedly improper use of

83. *See infra* Exhibit 9 p. 150 (explaining that 110 out of 154 federal enforcement actions were initiated by the CFTC during the time period examined).

derivative instruments by pension fund sponsors or fund managers in violation of the Employee Retirement Income Security Act of 1974 ("ERISA").[84]

Regulatory Agency	1994	1995	1996	1997	1998	1999	2000	Total Cases
CFTC	18	17	13	14	13	27	8	110
SEC	9	1	1	8	9	1	9	38
DOL	0	0	0	1	4	0	1	6
Total Cases	27	18	14	23	26	28	18	154

Exhibit 9: Number of Cases Filed According to Regulatory Agency - 1994 through 2000.

Allegation	1994	1995	1996	1997	1998	1999	2000	Total Cases
Breach of Contract	12	11	9	1	6	11	12	62
Breach of Fiduciary Duty	13	39	8	8	14	40	16	138
Fraud	23	36	20	3	18	21	20	141
Negligence	13	8	8	3	3	14	4	53
Negligent Misrepresentation	16	34	11	6	26	24	6	123
Securities Fraud	37	33	9	14	25	31	14	163
Total	114	161	65	35	92	141	72	680

Exhibit 10: Number of Cases Filed According to the Nature of the Allegation - 1994 through 2000.

84. *See* Employee Retirement Income Security Act of 1974, 29 U.S.C. §§ 1001-1461 (2000). *See, e.g.*, Alexia M. Herman, Secretary of Labor v. First Capital Mortgage, No. 00-CIV-0557 (N.D.Ala. filed Mar. 6, 2000); *see also infra* Exhibit 9 p. 150.

VIII. CASES BY NATURE OF THE ALLEGATION

The most common allegation cited in cases filed between 1994 and 2000 is securities fraud. Common law fraud, breach of fiduciary duty, and negligent misrepresentation are each alleged in a third or more of the derivatives cases. Negligence and breach of contract have been alleged less often.[85]

Many of the derivatives cases involve multiple allegations. The percentage of cases alleging securities fraud peaked at 40% in 1997[86] and has since declined to 19% in 2000.[87]

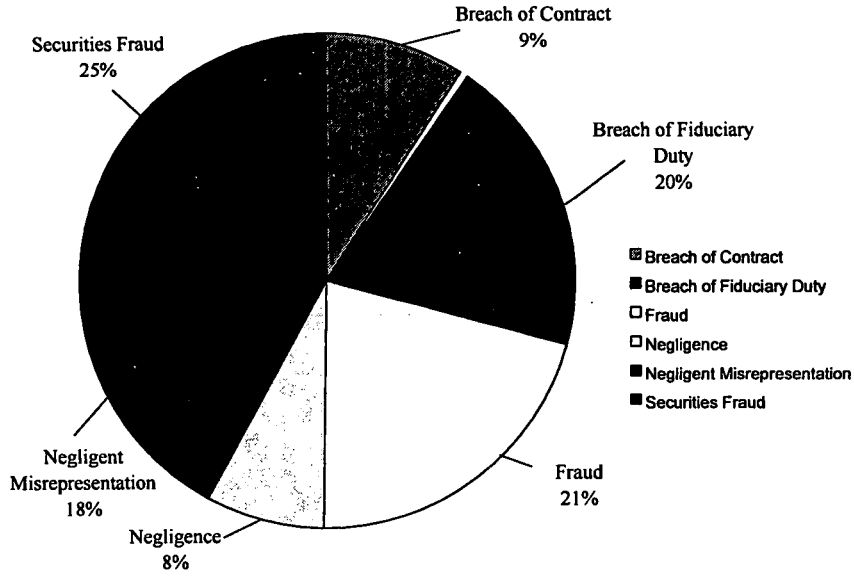

Exhibit 11: Percentage of Cases Filed According to Type of Allegation - 1994 through 2000.

In these cases, plaintiffs generally allege that the defendants either failed to disclose material information or disclosed

85. *See supra* Exhibit 10 p. 150; *see also infra* Exhibit 11 p. 151.

86. *See supra* Exhibit 10 p. 150. Fourteen out of a total of thirty-five cases alleged securities fraud in 1997. *Id.*

87. *See id.* Fourteen out of a total of seventy-two cases alleged securities fraud in 2000. *Id.*

misleading information about the derivative instrument, the underlying assets, or the performance of the investments.[88] The improper disclosure is then alleged to have prevented the plaintiff from fully understanding the derivative instrument's true risk-return characteristics or made it impossible for the plaintiff to value it correctly.[89] In essence, the plaintiffs argue that poor information caused their losses.

A. Representative Cases

In *Laser Mortgage Management, Inc. v. Asset Securitization Corporation,*[90] Laser Capital Mortgage ("Laser") alleged that the defendant concealed material adverse information regarding a large loan underlying $19 million in mortgage pass-through certificates that it purchased from the defendant.[91] The securities were backed by a trust containing a pool of commercial and multifamily residential mortgages,[92] one of which was allegedly "seriously troubled" from the outset.[93] Laser bought subordinated CMO[94] classes,[95] which had the greatest exposure to default risk, and the default of the large commercial loan rendered Laser's CMO securities virtually worthless.[96] Laser argued that the defendant's material misrepresentations and omissions constituted securities fraud, which Laser blamed for its investment loss.

In *Korea Life Insurance Co. v. Morgan Guaranty Trust Co. of New York,*[97] the plaintiff alleged that it was defrauded by Morgan Guaranty on a total return swap.[98] The swap counterparty was

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88. *See infra* Part VIII.A. (providing examples of cases).

89. *See, e.g.,* Laser Mortgage Mgmt. v. Asset Securitization Corp., No. 00-CIV-810, 2001 U.S. Dist. LEXIS 13746 (S.D.N.Y. Sept. 2000).

90. *See id.* *2-14.

91. *See id.*

92. *See id.*

93. *See id.*

94. *See supra* note 15 and accompanying text (providing a definition of CMOs).

95. *See Laser Mortgage Mgmt.*, 2001 US Dist. LEXIS at *2-14.

96. *See id.*

97. Complaint, Korea Life Ins. Co. v. Morgan Guar. Trust Co. of N.Y., No. 99-CIV-12175 (S.D.N.Y. dated Dec. 20, 2000).

98. *See id.* at 6.

Malaysia-based Morning Glory Investment Inc. ("Morning Glory"), a trust created by Morgan Guaranty to facilitate a total return swap for the benefit of Korea Life.[99] The payments at issue were between Morning Glory and Morgan Guaranty based on the performance of the Japanese yen in relation to the Thai baht and the U.S. dollar.[100] Korea Life agreed to act as guarantor for Morning Glory if the Malaysian company was unable to meets its swap obligations.[101] Korea Life alleges that Morgan Guaranty knew that the Thai government was about to devalue the baht when it entered into the total return swap with Morning Glory and Korea Life agreed to guarantee the swap counterparty's obligations.[102] According to the complaint Morgan Guaranty remained silent about the devaluation of the baht because it stood to gain millions of dollars from the devaluation as the recipient of Korea Life's guarantee payments.[103] Whether a financial institution such as Morgan Guaranty could possibly have known about the devaluation beforehand is likely to be a very contentious issue, but similar allegations have been made against large financial institutions in other derivatives cases.[104]

> Total return swaps involve the exchange of the total return of an underlying credit sensitive asset for either some other cash flow which is usually pegged to LIBOR or for another credit sensitive asset. Under a total return swap, one party, referred to as the receiver, receives cash flows produced from the reference asset in exchange for paying to the second counterparty some reference rate plus or minus a spread. When the swap matures, the second party pays the receiver any reference asset price appreciation, while the receiver must pay the second counterparty any reference asset price depreciation.

Willa E. Gibson, *Are Swap Agreements Securities or Futures?: The Inadequacies of Applying the Traditional Regulatory Approach to OTC Derivatives Transactions*, 24 IOWA J. CORP. L. 379, 388 (1999).

99. *Korea Life Ins. Co*, No. 99-CIV-12175, at 6.

100. *See id.* at 8.

101. *See id.* at 16.

102. *See id.* at 11.

103. *See id.*

104. *See, e.g.*, Slovnaft, A.S. v. Merrill Lynch Int'l, Inc., No. 99-CIV-603760 (N.Y. Sup. Ct. dated Aug. 9, 1999). In this case, the plaintiff alleged that the defendant fraudulently misrepresented that transactions involving derivative-embedded loans would provide Slovnaft with low-cost, low-risk financing and that if the price of Brent crude oil fell below the strike price of $15 per barrel, Slovnaft would be financially protected by a "natural hedge" that would result in

Another case involving allegations of fraud is *Sumitomo Corporation v. The Chase Manhattan Bank.*[105] Sumitomo alleged that Chase knew about a Sumitomo rogue copper trader, Yasuo Hamanaka, who was losing millions of dollars on copper derivatives trades,[106] but loaned him the money disguised as copper commodity swaps in order to keep the Sumitomo account and gain the huge profits it stood to make on the swaps transactions.[107] Sumitomo's amended complaint alleges violations of RICO[108] and makes claims for fraud, aiding and abetting fraud, aiding and abetting breach of fiduciary duty, tortious interference with fiduciary duty, negligence, and rescission of financing agreements for fraud, lack of authority and lack of consideration.[109]

Breach of fiduciary duty and fraud were the primary causes of action in *Amada Co. Ltd. v. Republic New York Securities Corp.*[110] In this case, Japan-based Amada Co. and two subsidiaries allege that bank holding company Republic New York Securities Corp. breached its fiduciary duty and committed fraud in the sale of $123 million in investment notes that subsequently lost nearly all of their value due to derivatives trading.[111] The suit also includes

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dramatically increased net profits. *Id.* In fact, any benefit to Slovnaft by reason of a fall in oil prices would diminish when set against the fall in value of the products sold by Slovnaft and against the additional interest payments due. *Id.* Plaintiffs further alleged that the proposed loans were not suitable for Slovnaft because embedded within each loan was a high-risk derivative element, which, in the event that the price of Brent crude oil fell below the strike price, would lead to very substantially higher interest payments. *Id.* The plaintiff claimed losses totalling $75 million. *Id.*; *see also* Frank Partnoy, *The Shifting Contours of Global Derivatives Litigation,* 22 U. PA. J. INT'L ECON. L. 421 (2001) (discussing in detail *Korea Life Insurance* and other similar cases).

105. Sumitomo Corp. v. Chase Manhattan Bank, No. 99-CIV-4004, 2000 US Dist. LEXIS 15707 (S.D.N.Y. Oct. 1999).

106. *See id.* at *3-7.

107. *See id.*

108. *See id.*

109. *See id.* at *7-11.

110. Amada Co. Ltd. v. Republic N.Y. Sec. Corp., No. 99-CIV-11602 (S.D.N.Y. filed Nov. 29, 1999); *see also N.Y. Brokerage Files Motion to Dismiss $123 Million Fraud Suit,* DERIVATIVES LITIG. REP., Mar. 6, 2000, at 3; *$123 Million Suit Pending Grand Jury Action, supra* note 5.

111. *See N.Y. Brokerage Files Motion to Dismiss $123 Million Fraud Suit, supra* note 110; *$123 Million Suit Pending Grand Jury Action, supra* note 5.

allegations that Republic New York Securities Corp. committed common law fraud, breached its fiduciary duty, and was unjustly enriched.[112]

Cary Oil Co., Inc. v. MG Refining & Marketing, Inc.[113] involves the alleged breach of long-term oil supply contracts called "flexies" that the defendant created and sold to the plaintiff in 1993.[114] MG Refining then sought to cancel the contracts after the CFTC ruled they were created solely to speculate on the future price of oil, without any intention on the buyer's part to ever take delivery, and amounted to illegal off-exchange futures contracts.[115] Cary Oil brought suit alleging breach of contract.

B. Representative Enforcement Actions

In *Commodity Futures Trading Commission v. IBS,*[116] four companies allegedly acted as a "common enterprise" to defraud investors by selling illegal commodity futures contracts.[117] The CFTC accused the companies' salespeople of touting the extraordinary profitability of investing in silver futures contracts without fully explaining the risks inherent in commodity derivative instruments.[118] The CFTC alleged that the principals of the defendant companies also attempted to conceal the companies' location from investors by maintaining a telephone number, but no office, in the Bahamas.[119] The defendants responded that the CFTC lacked jurisdiction because the defendants claimed they were in the business of selling metal (mainly silver), not futures

112. Amada Co. Ltd. v. Republic N.Y. Sec. Corp., No. 99-CIV-11602 (S.D.N.Y. filed Nov. 29, 1999); *see also N.Y. Brokerage Files Motion to Dismiss $123 Million Fraud Suit*, DERIVATIVES LITIG. REP., Mar. 6, 2000, at 3; *$123 Million Suit Pending Grand Jury Action, supra* note 5.

113. *See* Cary Oil Co., Inc. v. MG Refining & Mktg., Inc., 90 F. Supp. 2d 401 (S.D.N.Y. Mar. 2000).

114. *See id.* at 404-05.

115. *See id.* at 404-08.

116. *See* Commodity Futures Trading Comm. v. IBS, 113 F. Supp. 2d 830 (W.D.N.C. June 2000).

117. *See id* at 833-42.

118. *See id.*

119. *See id.*

contracts.[120]

In an action brought against Scudder Kemper Investments,[121] the SEC charged Scudder and Gary Paul Johnson, head of the firm's trading division, with supervisory and record keeping violations[122] under the Investment Advisers Act of 1940[123] and Investment Company Act of 1940.[124] A Scudder's derivatives trader was the named defendant in a second action.[125] The alleged misconduct resulted in losses of more than $16 million and rendered inaccurate the registrant's books and records. Both cases settled with Scudder accepting SEC sanctions early in 2000, including a $250,000 fine, without admitting or denying the charges.[126]

In another action brought by the SEC, *In re Piper Capital Management Inc.*,[127] an administrative law judge ruled that Piper violated the anti-fraud provisions of the Securities Act of 1933[128] and the Securities Exchange Act of 1934[129] by failing to disclose the volatile and interest-rate-sensitive nature of collateralized mortgage obligations,[130] which made up a large part of the Piper Jaffray Institutional Government Income Portfolio mutual fund. On November 30, 2000, Piper was assessed monetary penalties totalling $2,005,000 for securities laws violations.[131]

Federal administrative actions involving derivative instruments have also been brought by the Department of Labor.

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120. *See id.*

121. *See In re* Scudder Kemper Inv. Inc. & Gary Paul Johnson, Admin. Proceeding File No. 3-10121, 1999 SEC LEXIS 2737 (Dec. 22, 1999).

122. *See id.* at 2.

123. 15 U.S.C. §§ 80b-1–80b-21 (2000).

124. *Id.* §§ 80a-1–80a-52; *see also Scudder*, 1999 SEC Lexis 2737, at *4.

125. *See Scudder,* 1999 SEC Lexis 2737, at *4.

126. *See Boston Derivatives Firm Fined $250K for Unauthorized Trades that Lost $16M*, SEC. COMMODITIES LITIG. REP., Jan. 26, 2000, at 5.

127. *See In re* Piper Capital Mgmt., Inc. v. Bruntjen., Admin. Proceeding File No. 3-9657, 2000 SEC LEXIS 2626 (Nov. 30, 2000).

128. 15 U.S.C. §§ 77a-77aa *et seq.* (2000).

129. 15 U.S.C. §§ 78a-78ll *et seq.* (2000).

130. *Piper Capital Mgmt.*, 2000 SEC LEXIS at *2-6.

131. *See* Judy Mathewson, *Piper Capital to Pay $2 MLN for Handling of Fund*, BLOOMBERG NEWS, Dec. 1, 2000.

U.S. Department of Labor v. First Capital Mortgage[132] is an ERISA case in which the Secretary of Labor accused the defendants of breaching their fiduciary duty and violating ERISA by investing in high-risk securities, call options, and warrants on behalf of an employee benefit plan.[133] Defendant Tim A. King, owner and president of First Capital Mortgage and trustee of the plan, allegedly breached his fiduciary obligations as plan trustee by making investments on behalf of the plan that created a high potential for loss and in fact resulted in significant losses to the employee benefit plan during 1994 and 1995.[134]

IX. CONCLUSION

There are approximately fifty derivatives-related cases filed in the federal courts or initiated by federal regulators each year. Derivative instruments are complex, and therefore relatively difficult to understand and value, and their volatility exposes derivatives users to potentially large losses during periods of heightened market volatility. When losses occur, lawsuits are quick to follow, usually alleging various forms of fraud. When funds suffer losses, fund mangers are exposed to the risk of suits alleging breach of fiduciary duty for using derivatives improperly, or in some cases, for using them in the first place.

Securities dealers continue to introduce new derivatives contracts. Recently introduced instruments include various types of energy derivatives, weather derivatives, and credit derivatives. These instruments are designed to reallocate risks among market participants in order to improve overall market efficiency. But while the new instruments create new hedging opportunities, they also entail legal risks because the newer instruments tend to be more difficult to understand and value than existing instruments and thus, more prone to occasional large losses. The litigation record from 1994 through 2000 suggests the possibility that users of

132. Herman v. First Capital Mortgage, No. 00-CIV-0557 (N.D. Ala. filed Mar. 6, 2000) Herman is named in this action in his position as the Secretary of Labor. *See id.*

133. *See id.* at 6.

134. *See id.* at 10.

these new instruments may be unwittingly substituting legal risk for the financial risks they are trying to shed. Derivative contracts, especially the newer and more exotic varieties, should bear a legend: these instruments may be hazardous to your wealth; use at your own (legal) risk.