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COMMON LAW THEORIES OF LIABILITY IN DERIVATIVES LITIGATION

*Aaron Rubinstein**

THE last three years have seen an explosion of reported problems with derivatives transactions and the number of litigations involving derivatives. Cases involving well-known financial institutions have focused public attention on derivatives and questions surrounding their various uses.

Statutes and industry rules have addressed a number of the problems presented by derivatives, and no doubt new ones will be promulgated; however, entities are looking to the common law for answers and are charting new territory in the process. Somewhat surprisingly, most of the key legal questions about derivatives remain unanswered. I will discuss the common law theories of derivatives liability that are evolving from my vantage point as a practitioner and the two issues most commonly litigated in the new derivatives arena—authorization and suitability.

I. An Overview of the Problem

A good way to briefly overview the problems with derivatives is to describe some of the more notable derivatives cases that have been brought.

A. *The Bankers Trust Cases*

In the fall of 1994, two companies filed separate suits against Bankers Trust seeking to avoid their derivatives losses and compensation for past losses.

1. *The* Gibson Greetings, Inc. *Case*

Bankers Trust was sued by Gibson Greetings, a relatively small company which, as its name suggests, was primarily a greeting card manufacturer. In 1991, Gibson issued $50 million in long-term fixed interest rate debentures. It alleged that in an effort to minimize its interest expenses, it entered into several interest rate swap transactions with the bank. Actually, there were 29 such transactions.

Gibson claimed that the bank misrepresented the periodic valuations of the swaps and led it to invest in extremely volatile and risky

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swaps. In its harshest claim, Gibson maintained that, with losses from one of its swaps astronomically increasing daily, the bank forced Gibson to enter into another swap to cap its losses, knowing that the future of the company was at stake. Gibson claimed it had no independent way to evaluate this new transaction, and that the bank gave it only hours to decide whether or not to enter into the deal. The bank's response was to generally deny the allegations. It attempted to portray Gibson as a large and sophisticated company, which was able to understand the nature of the investments. On November 23, 1994, the parties announced that they had settled the dispute. Gibson agreed to pay the bank approximately $6 million, or roughly 30% of what the bank claimed it was owed. Thus, the legal community was denied the opportunity to see this matter decided in court.

2. *The* Procter & Gamble *Case*

Procter & Gamble, one of the largest and seemingly most sophisticated American companies, sued the bank over an interest rate and a currency swap seeking to recover nearly $200 million in compensatory damages, along with punitive damages. Procter & Gamble asserted a wide range of theories under statutory and common law. Most notably, it claimed that the bank misled it as to the terms of the transactions. Procter & Gamble asserted that it had specific and limited purposes for doing the swaps, that the bank knew that, and that it did not want to undertake trades that had substantial downside risks. It then asserted that it could not itself fully understand the nature of the trades the bank proposed and that it relied on the bank to determine that the trades met Procter & Gamble's goals and criteria. Procter & Gamble, one of the largest U.S. conglomerates, was saying that, with all its Harvard MBAs, it did not understand what it was investing millions of dollars in.

It also claimed that the bank intentionally misled it on the transactions. This led to claims that the bank defrauded Procter & Gamble and that the bank, as a fiduciary, breached its duty to Procter & Gamble. Not surprisingly, the bank stressed Procter & Gamble's financial sophistication and the suitability of the derivative products to Procter & Gamble's investment goals and strategies. It denied any fiduciary relationship and that it ever misled Procter & Gamble.

In May, 1996, the parties settled with Procter & Gamble receiving approximately $100 million of the $200 million it sought. This settlement—maybe not coincidentally—came after a highly publicized dispute wherein Business Week printed quotes from tapes of telephone conversations made by the bank's employees. Those tapes made a big splash in the media and Procter & Gamble argued that the tapes showed that the bank was guilty of lying, cheating, and stealing from its clients.

Something that has gone somewhat unnoticed is that just prior to the settlement, the district court in Ohio entered an opinion which was, in many respects, the first attempt to chart the waters of the relationship between a broker and a customer in the derivatives marketplace under U.S. law.[1] At the outset, though, it is important to understand that this case was somewhat atypical. There is a wide spectrum of aggrieved customers that could bring suits and Procter & Gamble was on one end of that spectrum, the proverbial widows and orphans being on the other end. The bank was being sued by Procter & Gamble, one of the largest corporations in the US—certainly an entity which most people would consider to be quite sophisticated. On a motion by the bank, the court had to determine several issues of first impression.

The court addressed what duties and obligations existed between the parties. Focusing on the fact that they were counter parties, the court applied New York law and found that the bank had not undertaken a fiduciary duty to Procter & Gamble. On this issue, the Court was somewhat conclusory and did not really explain its decision, other than to cite to some New York cases finding no fiduciary duty in normal arms length business relationships among companies.[2] Significantly, the court did not review any contentions that the bank was advising Procter & Gamble, and simply pronounced that the two companies were contracting at arms-length.

Even if the bank and Procter & Gamble truly were contracting at arms-length, it is apparent that many derivatives users are not. They repose trust in sellers to advise them and act in the company's best interest. The *Procter & Gamble* decision does not answer the question of whether a fiduciary duty arises in those situations. Again, there is a spectrum, and all the *Procter & Gamble* decision tells us is "not at this end." The *Procter & Gamble* decision is, therefore, fact specific. A fiduciary relationship can exist, but did not under the facts of that case.

But the court did find that the bank could be liable to Procter & Gamble if certain facts could be proved. The court found that the bank had a duty of good faith and fair dealing inherent in every contract and, under New York law, had a duty to disclose information during the negotiation and performance of the transactions because it had superior knowledge.[3]

1. Procter & Gamble Co. v. Bankers Trust Co., 925 F. Supp. 1270 (S.D. Ohio 1996).
2. *Id.* at 1289-90.
3. *Id.* at 1290.

B. *Orange County*

It has been widely publicized that Orange County, California filed for bankruptcy after experiencing a multi-billion dollar loss in its investment fund. Primarily through Merrill Lynch, Orange County invested billions of dollars in "inverse floaters," which were largely financed by "reverse repose." Orange County has sued Merrill Lynch over these transactions, asserting that its derivatives transactions are null and void. It seeks additional damages of $2 billion. Orange County claims that its derivatives transactions violated certain provisions of the California Constitution and related state laws regarding municipal finance. These provisions make the transactions unauthorized because Orange County did not have the ability to enter into them as it claims Merrill Lynch knew. In addition, it asserts claims of breach of fiduciary duty and common law and statutory fraud similar to what we saw in the bank cases. The litigation between Orange County and Merrill lynch is ongoing. The case has yet to yield any real jurisprudence on suitability or authorization.

C. *The* Lehman vs. Minmetals *Case*

That brings me to the case that I am in the midst of now, the *Lehman v. Minmetals* case. It is a good example of the type of case that involves both of the primary issues of authorization and suitability. Much of what is alleged and involved is a matter of public record, and I am limited in what I can discuss to that public information.

In November, 1994, Lehman Brothers filed suit against two Chinese companies, seeking to recover derivatives trading losses which Lehman says those companies incurred. From the time the complaint was filed, Lehman portrayed its suit as a case involving a simple contract dispute, and a case of Chinese companies being unwilling to pay their debts. The Minmetals companies counter-attacked. They focused on two items: derivatives and the inequality between the seller and customer relating to experience, knowledge, and sophistication. This inequality affects the duties and obligations of the seller. The *Minmetals* case will test those duties in the context of a large U.S. financial institution dealing with a foreign company which had no prior experience in these types of transactions; a company which, like many foreign companies doing such transactions, was just entering the stream of complex international financial transactions.

Specifically, Minmetals asserted its claims based on the facts that the transactions: 1) were made with an unauthorized employee; 2) were illegal under Chinese law; and 3) were subject to statutory and common law fraud claims, breach of fiduciary duty and negligence. Two of these issues will be my focus today; namely, authorization of employees to engage in derivatives transactions, and the suitability of those transactions even if the employee was authorized.

From these cases—and the well publicized Barings situation—it is easy to see that there are three characteristics that are most likely to cause a problem: disputed losses are most common when the derivative products being traded are *complex*, where the investor has *leveraged* itself to make the deal, and where the sheer *size* of the investment is too large for the particular investor. Thus, two lines of defense are emerging—authorization and suitability.

II. AUTHORIZATION

Some customers are claiming that the employees who entered into derivatives transactions on their behalf never had the requisite corporate authority to do so. They point to a lack of due diligence on the part of the seller in investigating whether the person with whom they dealt could act for the corporation. This claim involves the assertion that the employee was somehow a renegade and the corporation was unaware of what was actually being done. This is grounded in common law agency doctrine.

There are three types of authorization: 1) express authority; 2) implied authority; and 3) apparent authority. A party must show that one of these three types of authority existed to bind a principal to the acts of its agent. Express and implied authority are rarely present—although sellers would be well advised now to get express authority as a condition before allowing trading.

A. *Apparent Authority*

Apparent authority is where the action is. Where there is evidence that shows that an agent acted with apparent authority, a principal may be bound, even though both express and implied authority are lacking. Apparent authority is authority which the principal either knowingly permits its agent to exercise or otherwise represents that the agent wields. It does not turn on the agent's actions. The agent's representations to a third party are not relevant. The key to a factual inquiry into apparent authority is the principal. Liability is imposed because the actions of a principal or an employer give the false impression that authority exists.

Two elements of apparent authority must be proven: 1) a showing that the principal somehow acted in a way that could be construed as consenting to the exercise of authority; and 2) a showing that the party asserting apparent authority was aware of the principal's actions and had a reasonable basis for concluding that the agent possessed the requisite authority based on the principal's conduct.

Practically, the key focus of the inquiry will be the reasonableness of the seller's reliance. Asking whether a party had a duty to inquire into an agent's apparent authority is another way of asking whether the third party reasonably relied on the representations of the agent.

A third party's duty to inquire into an agent's apparent authority arises when: 1) the facts and circumstances are such as to put the third party on inquiry; 2) the transaction is extraordinary; or 3) the novelty of the transaction alerts the third party to a danger of fraud or improper conduct. Unusual or novel transactions (like many derivatives contracts) may be deemed to put a party on notice. Similarly, transactions which are inconsistent with the needs of the company or investor can give rise to a duty of inquiry.

Authorization was not an issue in *Gibson Greetings*, but the facts offer an example of how it could have been. When a relatively small greeting card company is undertaking large complex investments to fundamentally change the financing of its debt—29 such transactions in a short period of time—one can see how the seller might be on notice to question the apparent authority of the person it was dealing with.

B. *Illegality*

A related attack on derivatives transactions has been to claim that the entire transaction was illegal and therefore void. While a defense in its own right, an illegality claim can support an assertion that the transactions were not authorized, and in fact could not be authorized. Minmetals' claim of illegality is illustrative.

Minmetals maintains that China places strict limits on foreign currency trading and speculative investments, and because the government did not authorize it to enter into those types of transactions, it is not responsible for them. Even if a customer cannot *avoid* the consequences of trading because the trades were illegal, customers that are challenging the employee's authorization assert that the seller knew or should have known that the trade violated the law and, if so, the seller could not have *reasonably* believed that the employee had the authority to do something that was illegal. This type of claim has so far been untested in the derivatives litigation arena.

The courts will have to decide whether sellers have a duty to determine if transactions are legal. But, even if the law will not impose such a duty on a seller, the seller may not be off the hook if it, in fact, *knew* about legal restrictions on the trading. For example, investment banks doing offerings and prospectuses in a foreign country often themselves elaborately disclose that the country has restrictions on foreign currency transactions. Such a seller will likely have a hard time avoiding an illegality defense—or at least asserting a reasonable reliance on apparent authority argument—by claiming it had no obligation to investigate the law.

III. SUITABILITY

Authorization requires understanding and comprehension of the product. It thereby ties into suitability, which is the other central issue raised in these litigations. My earlier point on the legal relationship between customers and sellers is largely a debate about who bears the responsibility for determining whether derivatives transactions are suitable for the individual customer. Because derivatives are often such complex and highly leveraged products, they intensify the suitability question.

For derivatives, there is no clear rule as to suitability. Litigants have pointed to different standards of care, seeking to apply them to derivatives. These standards have not been extensively tested in the courts. As I previously discussed, a court in Ohio was unwilling to relieve Procter & Gamble of an independent duty to determine suitability for itself. Who would it relieve of such a duty?

Suitability assertions manifest themselves in two primary claims: 1) breach of fiduciary duty; and 2) fraud. The battle over the legal relationship between the buyer and seller often focuses on the term "fiduciary." While customers maintain that the seller was a fiduciary, the sellers maintain that legally they are no more than a counter-party to an arms-length derivatives contract. Indeed, on some level, they are both correct. It is often the case that the seller performs a dual role in derivatives trading. On the one hand, it advises the customer and, as customers have alleged, is engendered with the customer's utmost trust and confidence. On the other hand, the seller is often the counter-party to the derivatives contract and, thus, the seller alleges that the transaction was negotiated at arms length.

Current litigation will have to resolve this inherent conflict in fleshing out exactly what the duties of the seller are in these dual roles. The *Procter & Gamble* case was a start. The court found that as a large and sophisticated company, Procter & Gamble was truly at arm's length with the bank. However, there will still be much litigation on the dual role as it applies to smaller and less savvy entities.

Do not assume that suitability applies only to demystifying complex transactions, for even simple transactions can be unsuitable if they are used in great quantities. Barings was not brought down by horribly complicated swaps; it was done in by relatively simple transactions—but billions and billions of dollars of them. Litigation will also have to answer this question: When does a customer understand the transaction, but in completing an inappropriately large volume of transactions, and thereby undertaking a very large risk, what duties, if any, does the seller have?

Under a fiduciary duty theory, the customer asserts that, as a fiduciary, the seller had the responsibility to determine that the product sold was inappropriate and unsuitable for the customer. This can be the result of the size, risk, and leverage of the product, a lack of relationship to the customer's core business or the customer's legitimate business needs, or simply because the product did not accomplish what the customer was trying to accomplish. The better equipped the customer is to make that determination for itself, the less likely it is that a fiduciary relationship will be created. Such a relationship is often the result of an imbalance of knowledge, ability, sophistication, and the like. The greater the imbalance, the greater the chance that a fiduciary relationship exists.

That brings us to fraud claims. Customers have alleged fraud in many forms. They assert traditional common law fraud, as well as fraud under the anti-fraud provisions contained in state and federal securities and commodities laws. In general, a customer must show that a seller made a false statement, with a wilful or reckless intent to deceive which was material and reasonably relied on by the customer. Customers have asserted that sellers have committed fraud in nearly all aspects of their dealings, from misrepresenting the nature and risks of the derivatives, to misrepresenting the value of the derivatives after execution.

Obviously, affirmative misrepresentations made on the subjects such as volatility, risk, and pricing can potentially create traditional fraud claims; there is nothing new about that. But even without affirmative misrepresentations, traditional fraud claims can arise from unsuitable investments. When a seller advises a customer to do a specific transaction—or even suggests it do it—there is an implicit representation that the investment is suitable. That is not to say that it is a sure bet, but rather that it is not something that is inappropriate for the customer. The issue becomes what obligations does the seller have to investigate the appropriateness? Can it base the recommendation on what little it knows about the customer, or is it obligated to expand its lack of knowledge to satisfy itself that it is appropriate? Often, these products are customized. The customer comes to the seller and says, "This is what I need to accomplish, can you design or sell me something to do that?" If the seller comes back with a product, it essentially is saying, "This is what you want." That is similar to an affirmative misrepresentation.

Arguably, when a company is on the brink of doing highly complex investments which are outside its core business competency, there is an obligation on the part of the seller to investigate suitability to ensure that the derivatives are not inappropriate. And if it does not, but says go ahead and do this trade, depending on how it says it—especially how enthusiastically it says it—it may be acting fraudulently.

CONCLUSION

In sum, there are thousands of different types of derivatives transactions, each of which is very different from the others. In that context, there is a much stronger case for imposing heightened obligations on the professionals. Put simply, many derivatives users seek advice from professionals because while the deals can be very beneficial for the customer, wading through the maze of different derivative products is too daunting to be done alone. In those situations, where the professional recommends what is inappropriate, somehow a claim is likely to exist.

Notes & Observations