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2017 DERIVATIVES LITIGATION ROUNDUP

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The year 2017 got off to an exciting start with the First Department's affirmance in *Good Hill Master Fund L.P. v. Deutsche Bank AG*, 146 A.D.3d 632 (1st Dep't 2017), in January, followed shortly thereafter by a two-day bench trial in the Commercial Division, New York Supreme Court in *BDC Finance LLC v. Barclays Bank PLC*, a long-running margin-call dispute arising out of the 2008 financial crisis.

The rest of the year was more prosaic. The torrent of derivatives-related disputes arising from the Lehman Brothers bankruptcy became a trickle. Class actions relating to alleged manipulation of financial benchmarks and alleged anticompetitive conduct in the derivatives markets took center stage. There also were a handful of decisions confirming some settled principles of law regarding the prerequisites for challenging a margin call in court, the propriety of Early Termination payments on swaps upon prepayment of associated loans, and the enforceability of contractual non-reliance provisions.

Good Hill Master Fund L.P. v. Deutsche Bank AG

Perhaps the most significant New York law derivatives decision in the past year was the Appellate Division, First Department's affirmance of the 2016 trial court decision in the *Good Hill* case. The dispute centers on the interpretation of Section 9.1(b)(iii) of the 2003 ISDA Credit Derivatives Definitions (now found in Section 11.1(b)(iii) of the 2014 ISDA Credit Derivatives Definitions), which states as follows:

> [E]ach party and its Affiliates and the Calculation Agent may deal in the Reference Obligation, each Obligation, each Deliverable Obligation and each Underlying Obligation and may, where permitted, accept deposits from, make loans or otherwise extend credit to, and generally engage in any kind of commercial or investment banking or other business with, the Reference Entity, any Underlying Obligor, any Affiliate of the Reference Entity or of the Underlying Obligor, or any other person or entity having obligations relating to the Reference Entity, any Underlying Obligor, or any Affiliate of the Reference Entity or of the Underlying Obligor, and may act (but is not obliged to act) with respect to such business in the same manner as each of them would if such Credit Derivative Transaction did not exist, regardless of whether any such action might have an adverse effect on the Reference Entity, any Underlying Obligor, any Affiliate of the

> Reference Entity or of the Underlying Obligor, or the position of the other party to such Credit Derivative Transaction or otherwise (including, without limitation, any action which might constitute or give rise to a Credit Event). . ..

In *Good Hill*, the plaintiff owned all of the notes in seven tranches, designated B6 through B12, of a residential mortgage-backed security issued by nonparty Bank of America Securities LLC.[1] Good Hill entered into CDS transactions with defendant Deutsche Bank that referenced only the B6 notes, under which Deutsche Bank stood to recover from Good Hill if there were a "writedown" of those notes.[2] Good Hill subsequently negotiated a sale of all seven tranches of its notes back to BofA at 29 cents on the dollar. If allocated *pro rata* to all seven tranches, that would have produced a writedown of 71%.[3] Good Hill asked BofA to allocate the entire purchase price to the B6 notes, which BofA rejected, although after some negotiations, it agreed to allocate 83% to the B6 notes, reducing the amount of the writedown on those notes to 17%.[4] Upon BofA's cancellation of the B6 notes, Deutsche Bank advised Good Hill that a writedown had occurred, triggering a payment by Good Hill.[5] The parties' agreements required Deutsche Bank to calculate the amount of the writedown (which, in turn, determined the amount of Good Hill's payment) based solely on BofA's report as servicer, which reflected the negotiated 17% writedown on the B6 notes. Deutsche Bank rejected the report as "potentially arbitrary and inconsistent with our understanding of the market valuation of the certificates prior to such allocation." Good Hill then demanded the return of $22 million in excess collateral, and Deutsche Bank refused, demanding support for BofA's allocation.[6] In 2010, Good Hill sued Deutsche Bank for breach of contract, and Deutsche Bank counterclaimed, alleging Good Hill had breached its obligations under the ISDA Master Agreement to act in good faith and a commercially reasonable manner.[7] After a bench trial, the court concluded that Good Hill had acted in good faith and a commercially reasonable manner, Section 9.1(b)(iii) expressly permitted Good Hill to act as it did, and Deutsche Bank had breached the agreement by refusing to return the collateral.[8] The trial court also awarded pre- and post-judgment interest at the contractual default rate of 21% based on Good Hill's certification of its cost of funds, which, after seven years of litigation, essentially quadrupled the amount of the judgment.[9]

Although there was some expectation that the trial court's decision might not survive appeal, the First Department affirmed the decision in all respects. *Good Hill* illustrates vividly the wide latitude that a CDS seller (or buyer) enjoys to further its own interests, including to the detriment of its counterparty. It also indicates that the obligation to act in good faith and a commercially reasonable manner in connection with a derivatives transaction can be significantly limited by other express provisions of the ISDA documentation.

Just as important, however, is the portion of the decision dealing with default interest. In *Good Hill,* the cost of funds used to determine the default rate of interest was particularly high because it was for a special purpose vehicle whose only assets were the funds and costs incurred at the time of Deutsche Bank's breach.[10] The court nonetheless did not question Good Hill's certification as to the SPV's cost of funds, finding that it was binding under the express terms of the ISDA Master Agreement. In light of this outcome, parties may wish to consider whether to include a provision (in their Schedule or otherwise) setting forth another way to determine a default interest rate.

The *BDC Finance* Trial

BDC Finance arises out of one in a series of competing margin calls issued by BDC and its total-return-swap counterparty Barclays in the chaotic market conditions that followed the Lehman Brothers bankruptcy filing in September 2008. The lawsuit was filed in October 2008, and in 2012, the parties' summary judgment motions were granted in part and denied in part. Both parties appealed, first to the Appellate Division, First Department, and then to the Court of Appeals (leave having been granted by the First Department), which remanded the case for trial having found that there were fact issues precluding summary judgment. After some skirmishing about the scope of trial, a two-day bench trial was conducted in April 2017. The parties filed proposed findings of fact and conclusions of law in June 2017, and the court has not yet issued a decision.

The decision in the case may provide new guidance for market participants about the dispute resolution provisions in Paragraph 5 of the ISDA Credit Support Annex. The primary issue in dispute at trial is whether Barclays' payment of $5 million satisfied its obligations under Paragraph 5 when BDC made a $40 million margin call and the "undisputed amount" on that call was $5.080 million. If so, BDC's termination of the parties' transactions was invalid; if not, Barclays may be liable to BDC for the full amount of the $40 million margin call, plus substantial interest.

Whatever the outcome, the case highlights the importance of a clear record of both the content and significance of all relevant communications when a party seeks to dispute a margin call. For example, after BDC made its now-disputed margin call, Barclays responded, "We do not agree with this call. Please let us know if you want to invoke the dispute mechanism." Given that Paragraph 5 contemplates a dispute being raised only by the party that *receives* a margin call, Barclays' suggestion of a dispute by the parting *making* the call is confusing to say the least. And, not surprisingly, the parties now disagree sharply about the import of Barclays' statement.[11]

Most Lehman Brothers Matters Have Wrapped Up

Since 2009, the primary source of new case law in the derivatives space has been the Lehman Brothers bankruptcy. Claims arising out of Early Terminations have raised novel issues of interpretation of the ISDA Master Agreement as well as the application of the U.S. Bankruptcy Code to Early Terminations triggered by bankruptcy. This year, as in prior years, many matters continued to work their way through the confidential mediation process, producing no case law whatsoever. Only a handful of very large adversary proceedings involving major derivatives dealers such as Citibank, Credit Suisse and JP Morgan Chase Bank remained pending as the year began. Each of these presented one or more novel legal issues, yet practitioners hoping to seeing these cases produce fresh guidance for market participants were largely disappointed as the Citibank and JP Morgan Chase Bank matters both ended with settlements in 2017.

The 2017 settlements leave the Lehman estate's adversary proceeding against Credit Suisse as the only major derivatives case still pending in the Bankruptcy Court. The Lehman estate challenges Credit Suisse's 16 proofs of claim seeking $1,188,525,210. Lehman asserts the claims should be reduced to approximately $75 million, and that under two of Credit Suisse's eight ISDA Master Agreements,[12] Credit Suisse owes the Lehman estates approximately $150 million. The complaints in the case as well as other filings in the public docket are vague but they suggest that the core issues in dispute involve Credit Suisse's valuation timing and methodology (including whether it netted exposures appropriately), how its valuations for Early Termination purposes compared to its risk management-driven valuations, and the validity of certain "charges" that Credit Suisse appears to have included in its Close-Out Amount calculations. Discovery is ongoing, and a trial in the Bankruptcy Court is scheduled to start on October 29, 2018. The only opportunity for a significant substantive decision in the coming year would be on the parties' summary judgment motions, although it is unclear at this stage whether there will be any such motions and, if so, whether the Court will decide them before a trial starts.

Benchmark Cases

While the Lehman cases have mostly wound down, class actions involving financial benchmarks have ramped up considerably. Of particular interest to derivatives market participants are the various "IBOR" cases, as well as the BBSW, FX and ISDAFIX cases. All of these cases involve financial benchmarks used in connection with derivatives transactions, but they vary in their scope. At one end of the size spectrum is the sprawling U.S. Dollar LIBOR multidistrict litigation, which currently consists of 46 cases consolidated for discovery before Judge Naomi Reice Buchwald in the Southern District of New York. These matters potentially involve a substantial portion of the USD interest-rate swaps market as well as Eurodollar futures and other instruments, and they encompass cases brought on behalf of a variety of putative classes as well as well as dozens of opt-out cases, all focused primarily on allegations of price-fixing in violation of the Sherman Act, although they include other claims. At the other end of the spectrum is the ISDAFIX case, which consists of five cases consolidated into a single case now pending before Judge Jesse M. Furman in the Southern District of New York. The ISDAFIX case targets the much narrower cash-settled USD interest rate swaptions market, although the plaintiffs have sought to expand it potentially to include not only physically settled swaptions but also various non-ISDAFIX-related instruments such as plain-vanilla swaps. The cases also differ in the misconduct they allege, with the USD LIBOR cases alleging unlawful *suppression* of that benchmark, and others alleging manipulation of those benchmarks both up *and* down. All of the benchmark cases, except for some of the USD LIBOR cases, are putative class actions. In the past year, several significant decisions were issued in these cases.

USD LIBOR: Several cases were dismissed in March 2013 for lack of antitrust standing, but that decision was reversed by the Second Circuit in 2016.[13] On remand, in late December 2016, Judge Buchwald decided a further motion to dismiss, finding the court lacked personal jurisdiction over some of the defendants, and that certain "bondholder" plaintiffs were not "efficient enforcers" of the antitrust laws.[14]

EURIBOR: This case involves Sherman Act, Commodity Exchange Act and RICO claims (as well as other common-law claims) based on an alleged conspiracy to manipulate the Euro Interbank Offered Rate. In February 2017, Judge P. Kevin Castel dismissed all claims except for two plaintiffs' Sherman Act, unjust enrichment and breach of the implied covenant of good faith and fair dealing claims against Citibank and JP Morgan. The dismissal was based on some plaintiffs' lack of antitrust standing, lack of personal jurisdiction over all of the foreign defendants, and other pleading defects such as plausibility and, for the RICO claims, extraterritorial predicate acts.[15]

Euroyen TIBOR/Yen LIBOR: These two cases involve in Sherman Act and Commodity Exchange Act claims based on an alleged conspiracy to manipulate the Euroyen Tokyo Interbank Offered Rate and the London Interbank Offered Rate for the Japanese yen as well as Euroyen TIBOR futures prices. In March 2017, Judge George B. Daniels issued two decisions in the *Laydon* case, one dismissing CEA claims for the period January 1 to January 30, 2011 due to the named plaintiff's lack of standing,[16] and the other dismissing all claims against three "new" defendants for lack of personal jurisdiction.[17] That same day, Judge Daniels also decided a motion to dismiss in the *Sonterra* case, finding the plaintiffs lacked Article III standing.[18] The *Sonterra* dismissal was appealed to the Second Circuit, but the case since has returned to the District Court as a result of some procedural skirmishes related to partial settlements of the case.

North Sea Brent Crude: These cases involve Sherman Act and Commodity Exchange Act claims (as well as other common-law claims) based on an alleged conspiracy to manipulate the market for North Sea Brent Crude oil in order to, in turn, manipulate various benchmarks that are calculated based on trading in that market and used in trading certain futures and derivatives. Motions to dismiss the action were fully briefed in March 2017. In June 2017, Judge Andrew L. Carter, Jr. issued two decisions on those motions, dismissing claims against one defendant based on lack of personal jurisdiction, and dismissing the claims of two sets of plaintiffs.[19]

SIBOR: This case involves Sherman Act and RICO claims (as well as other common-law claims) based on an alleged conspiracy to manipulate the Singapore Interbank Offered Rate and the Singapore Swap Offer Rate. In August 2017, Judge Alvin K. Hellerstein partially granted a motion to dismiss, and granted the plaintiffs leave to amend except with respect to their unjust enrichment claim.[20]

CHF LIBOR: This case involves Sherman Act, Commodity Exchange Act and RICO claims (as well as other common-law claims) based on an alleged conspiracy to manipulate Swiss franc LIBOR. In September 2017, Judge Sidney H. Stein dismissed the complaint in its entirety with leave to replead.[21] The deadline for any amended complaint was extended to November 6, 2017 and no further pleading has been filed in the public record. In any event, the most interesting feature of Judge Stein's decision is that, unlike nearly all other courts in the District that have considered the issue, he held there *was* personal jurisdiction over various foreign bank defendants. Specifically, he held "that transacting in CHF LIBOR-based derivatives in the United States after manipulating CHF LIBOR for the purpose of wrongfully increasing the profits of those transactions constitutes 'purposeful availment' of the forum."[22]

BBSW: This case involves Sherman Act, Commodity Exchange Act and RICO claims (as well as other common-law claims) based on an alleged conspiracy to manipulate an Australian interest rate benchmark known as the Bank Bill Swap Reference Rate ("BBSW"). Motions to dismiss the action were fully briefed in March 2017. In October 2017, the defendants filed a supplemental motion to dismiss on the grounds that four of the five named Plaintiffs (who also were plaintiffs in the CHF LIBOR case) had been dissolved before the lawsuit was filed.[23]

The benchmark cases involve issues that are not particular to the derivatives markets, but they do present a number of issues that are of potential interest to derivatives users. One is the construction of the jury waivers which dealers commonly include in the Schedule to the ISDA Master Agreement, including whether they apply to antitrust and other claims that are not strictly related to the construction of the contractual documents. Another important question is whether some market participants, in settling prior class actions involving derivatives (e.g., the municipal derivatives price fixing cases), may have released (directly or as class members) some or all of the claims asserted in these cases. The coming year may yield some important decisions in these cases, particularly as the USD LIBOR class cases and the ISDAFIX case move into class-certification motion practice. There also are appeals pending before the Second Circuit in some cases that are part of the USD LIBOR matter, which currently are being briefed and may be decided before the end of 2018.

Non-Benchmark Antitrust Claims

In addition to the benchmark cases, there are a number of antitrust cases alleging monopolization of various aspects of the derivatives markets. Many market participants will be familiar with *In re Credit Default Swaps Antitrust Litigation,* which alleged a conspiracy to prevent price transparency and competition in the United States CDS market. That case settled for over $1.86 billion, with payments to class members being completed at the end of 2016.

Still ongoing is *In re Interest Rate Swaps Antitrust Litigation*, a multi-district litigation comprising ten cases filed in 2015 and 2016 which allege a conspiracy to prevent three startup trading platforms from entering the U.S. market for interest rate swaps. The cases are consolidated before Judge Paul A. Englemayer in the Southern District of New York, who trimmed the case considerably by dismissing the Sherman Act claims for the period 2008 to 2012, leaving only claims for 2013 to 2016, and dismissing and limiting some plaintiffs' other claims and dismissing all claims against three defendants.[24] After a decision on the defendants' motions to dismiss was issued in July 2017, fact discovery began in August. A schedule for class certification motions has not yet been set and it seems unlikely at this point that any substantive decisions will be forthcoming in 2018.

Loan/Margin Call/ET Cases

The past year also brought a typical crop of cases involving a number of issues that have surfaced repeatedly in derivatives litigation.

Margin Calls: One issue is whether a breach of contract claim can be asserted in connection with a disputed margin call under the ISDA Credit Support Annex ("CSA"). Paragraph 5 of the standard-form CSA contains a dispute resolution procedure for margin calls, which has long frustrated some market participants, because it can be toothless and ineffectual in addressing anything but the most blatant errors in margin calculation. In 2008, Judge Barbara S. Jones held that a plaintiff's failure to use the mechanism in Paragraph 5 required dismissal of its contract claim challenging a margin call.[25] Other courts subsequently have agreed, and this "exhaustion" requirement has become settled law in the Southern District of New York. This trend was confirmed this past year in a decision by Judge Robert W. Sweet, who held in *Negrete v. Citibank, N.A.* that a plaintiff challenging a margin call under the ISDA Credit Support Annex could not state a contract claim because it had not alleged affirmatively that it "contested the[] margin calls within the required window" specified in Paragraph 5.[26]

Early Termination of a Swap Associated with a Loan: Another issue often arises in connection with commercial loan transactions in which a borrower enters into a loan transaction at a floating rate of interest, which it "converts" to a fixed rate through an interest rate swap. If the borrower prepays the loan, a question may arise as to what happens to the swap, which usually is terminated at the same time. There are several reported cases in which borrowers have attempted to avoid Early Termination payments by arguing, broadly speaking, that a demand for an Early Termination payment on the swap breaches a "no prepayment penalty" provision in the loan documents.[27] Such claims generally fail, with courts enforcing a dealer's right to an Early Termination payment, but the payments at issue are often extremely large, and customers continue to bring these claims in an effort to avoid them.

The issue was decided again earlier this year in *Compass Bank v. Durant*,[28] which was an appeal from a November 2015 decision by a Texas state trial court holding that a "no prepayment penalty" provision in a promissory note *did* preclude a lender from requiring an Early Termination payment on the associated interest-rate swap. The trial court granted summary judgment in favor of the plaintiff Jerry Durant on his contract claim, finding that he "had the right to prepay the amount owed under the Promissory Note without payment of any penalty or fee, including any fee claimed by Compass under the Master Agreement, Schedule, and Confirmation."[29] The Texas Court of Appeals reversed, concluding there was no inconsistency between, or ambiguity in, the note and the swap documents, and an Early Termination payment on the swap did not violate a provision stating there would be no penalty upon prepayment of the loan. As in many of these cases, the borrower argued that the documents he executed did not accurately reflect his understanding of the consequences of prepayment. In light of the absence of ambiguity in the documents, however, the court declined to take into account any evidence of Durant's understanding and wishes.[30]

Non-Reliance Provision: A third issue is whether claims for fraud and breach of fiduciary duty can be asserted against a swap counterparty. Dealers commonly include non-reliance language in the Schedule to a 1992 ISDA Master Agreement, and the 2010 ISDA Master Agreement contains a non-reliance provision. Depending on the exact language, these disclaimers of reliance have been held to bar claims for fraud, negligent misrepresentation and breach of fiduciary duty.[31] This issue also came up in the *Negrete* case, described above, and Judge Sweet held that the plaintiffs' fraud claim was barred, because they could not allege reasonable reliance given the non-reliance language in the 2010 form of the ISDA Master Agreement.[32]

ENDNOTES:

[1]*See Good Hill,* 146 A.D.3d at 633.

[2]*See id.* at 633-34.

[3]*See id.* at 634.

[4]*See id.*

[5]*See id.* at 635.

[6]*See id.*

[7]*See id.*

[8]*See id.* at 636.

[9]*See id.* at 637.

[10]*See id.*

[11]*See, e.g., BDC Finance L.L.C. v. Barclays Bank PLC*, Index No. 0650375/2008, Dkt. No. 445, ¶¶ 16-18.

[12]For each ISDA Master Agreement, Credit Suisse filed two proofs of claim, one against the Lehman counterparty and the other against Lehman Brothers Holdings Inc., as guarantor.

[13]*See Gelboim v. Bank of Am. Corp.,* 823 F.3d 759 (2d Cir. 2016), *cert. denied*, 137 S. Ct. 814 (2017).

[14]*See In re LIBOR-Based Financial Instruments Antitrust Litig.,* No. 11 MDL 2262 (NRB), 2016 WL 7378980 (S.D.N.Y. Dec. 20, 2016).

[15]*See Sullivan v. Barclays PLC,* No. 13-CV-2811 (PKC), 2017 WL 685570 (S.D.N.Y. Feb. 21, 2017).

[16]*See Laydon v. Bank of Tokyo-Mitsubishi-UFJ, Ltd.,* No. 12 Civ. 3419 (GBD), 2017 WL 1093288 (S.D.N.Y. Mar. 10, 2017).

[17]*See Laydon v. Bank of Tokyo-Mitsubishi-UFJ, Ltd.,* No. 12 Civ. 3419 (GBD), 2017 WL 1113080 (S.D.N.Y. Mar. 10, 2017).

[18]*See Sonterra Capital Master Fund, Ltd. v. UBS AG*, No. 15 CIV. 5844 (GBD), 2017 WL 1091983 (S.D.N.Y. Mar. 10, 2017).

[19]*See In re North Sea Brent Crude Oil Futures Litig.,* No. 13-MD-02475 (ALC), 256 F. Supp. 3d 298 (S.D.N.Y. 2017); *In re North Sea Brent Crude Oil Futures Litig.,* No. 13-MD-02475 (ALC), 2017 WL 2535731 (S.D.N.Y. June 8, 2017).

[20]*See FrontPoint Asian Event Driven Fund, L.P. v. Citibank, N.A.,* No. 16 Civ. 5263 (AKH), 2017 WL 3600425 (S.D.N.Y. Aug. 18, 2017).

[21]*See Sonterra Capital Master Fund Ltd. v. Credit Suisse Grp. AG*, No. 1:15-CV-00871 (SHS), 2017 WL 4250480 (S.D.N.Y. Sept. 25, 2017).

[22]*Id.* at *50.

[23]*See Dennis v. JPMorgan Chase & Co.,* No. 16-CV-06496 (LAK) (S.D.N.Y.), ECF No. 184.

[24]*See In re Interest Rate Swaps Antitrust Litigation,* No. 16-MD-2704 (PAE), 2017 WL 3209233 (S.D.N.Y. July 28, 2017).

[25]*See VCG Special Opportunities Master Fund Ltd. v. Citibank, N.A.*, 594 F. Supp. 2d 334, 343 (S.D.N.Y. 2008) ("As VCG was aware of the expedited Dispute Resolution clause set forth in the CDS Contract, VCG cannot now challenge Citibank's request for additional collateral without having first vetted this claim in the manner agreed upon in the CDS Contract."), *aff'd,* 355 F. App'x 507 (2d Cir. 2009).

[26]*Negrete v. Citibank, N.A.,* 237 F. Supp. 3d 112, 129 (S.D.N.Y. 2017). The case was decided in February 2017, and a notice of appeal to the Second Circuit was filed in September. No briefing schedule has been set for the appeal.

[27]*See, e.g., BKB Props., LLC v. SunTrust Bank*, 453 F. App'x 582, 586 (6th Cir. 2011) ("BKB's ability to prepay the Note without penalty is not dispositive of its obligations with respect to the interest-rate swap," which required Early Termination payment); *U.S. Bank Nat'l Ass'n v. Ables & Hall Builders,* 696 F. Supp. 2d 428, 445 (S.D.N.Y. 2010) (similar); *but see Banco Espirito Santo, S.A. v. Concessionaria Do Rodoanel Oeste S.A.,* 100 A.D.3d 100, 107 (1st Dep't 2012) (Early Termination payment not required where loan prepayment was not an Early Termination Event and was explicitly excluded

from "Close-out Amount" computation).

[28]516 S.W.3d 557 (Tex. Ct. App. 2017).

[29]*See id.* at 565.

[30]*See id.* at 569.

[31]*See, e.g., JPMorgan Chase Bank, N.A. v. Controladora Comercial Mexicana S.A.B. De C.V.,* 920 N.Y.S.2d 241 (Sup. Ct. (N.Y. Cty.) 2010) ("the plain terms of the [Schedule to the] ISDA Agreement bar CCM's affirmative defenses and counterclaims for fraud and negligent misrepresentation"); *Exec. Mgmt. Servs., Inc. v. Fifth Third Bank*, No. 1:13-CV-582-WTL-MJD, 2016 WL 3881220, at *16 (S.D. Ind. July 12, 2016) (facts not sufficient to support finding that "special circumstances" of parties' relationship created fiduciary duty especially in light of disclaimers of fiduciary relationship in contracts governing swap transactions at issue).

[32]*See Negrete,* 237 F. Supp. 3d at 124.