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Financial and Economic Crisis – Law Firms

Hurt By The Crisis – Consider The Litigation Remedy

The Editor interviews **Joshua K. Leader**, *Leader & Berkon LLP* and **Matthew Allen**, *Eversheds LLP*.

Editor: Matthew, please tell us about your role at Eversheds.

Allen: I am head of the financial services dispute management team here at Eversheds in London. That involves three key areas: first, wholesale market disputes within the London and European markets – involving securitizations, capital markets products, fund management and syndicated lending; second, disputes relating to retail distribution issues; and third, involvement in FSA enforcement proceedings and the like.

Editor: Josh, what is your role at Leader & Berkon?

Leader: I'm a partner at Leader & Berkon in New York City. We are a litigation firm with a fairly broad practice. A large percentage of our work falls into complex commercial and securities litigation and increasingly involves clients in the areas of private equity and, more recently, corporations that have been involved in trading in the derivatives markets. Companies frequently come to us for advice as they attempt to unravel the problems that have been created by the global economic crisis.

Editor: Matthew, how do you view the crisis?

Allen: This crisis is starting to look increasingly like three distinct phases. The first was a sort of paralysis as companies tried to sort out what their exposures were, the second started with the collapse of



**Joshua K.
Leader**



**Matthew
Allen**

Lehman, which has led to a major shake-out – Lehman was a counterparty to a huge number of European swap transactions – and the third phase is one which is only really starting now – that is a process of retribution and recovery.

The market has gotten much worse and is clearly not coming back any time soon. People have gotten a much clearer picture of their losses than was the case even back in the early summer. What that means is that, while there's still a desire to work out a lot of these issues amicably and through economic settlement or buyback, or whatever, increasingly hands are being forced because the losses can't be sat on any longer. Where there are claims based on conflicts of interest or other causes for concern, they are being pushed more aggressively now than they were six months ago. As we move into next year, more people will be reviewing their legal options, including both regulatory relief and litigation.

Editor: Do you see the same trend here in America, Josh?

Leader: Yes, it has become more and more difficult for companies that were involved in ISDA transactions to maintain the collateral obligations under those agreements or to find ways to replace the

collateral that the banks are insisting on. Given the liquidity issues in the marketplace, both sides to these transactions are very sensitive to how these deals will be worked out. I think we're likely to see a wave of litigation coming out of this.

Editor: Has the fluctuation in exchange rates complicated these problems?

Allen: Yes. The relationship between the pound and the dollar has in recent memory been characterized by modest volatility. But in the last three months there has been what can only be described as a complete collapse in the pound as against the dollar. As recently as the early part of the summer, the pound was trading at 2.10 or even higher, and now it's down to 1.3 or 1.4.

What that means, picking up on what Josh was saying, is that a lot of global corporations need to convert dollars, which they'll be earning internationally, back into pounds. Their hedging strategy, which historically has been based on traditional volatilities, has been absolutely trashed by the incredibly large movement in the last couple of months.

What you suddenly have now is a stock market where the pound is 1.3 or 1.4 to the dollar, with a lot of global corporations with strike prices at around 2 or just lower than 2. There's a double whammy here in that not only have they got a dreadful strike price relative to the market at the moment, but, because of the slowdown globally, business is drying up, so they're not getting the flow of dollars that they need to be able to feed some of these futures contracts.

We've seen a couple of cases recently where you have the incredible situation of a large global corporation having to buy dollars in the spot market – at 1.3 or 1.4 –

Please email the interviewees at jleader@leaderberkon.com or matthewallen@eversheds.com with questions about this interview.

to feed a long-term forward contract that's got at a strike price of around 2. So they're losing money hand over fist. It's causing huge problems.

Leader: The fluctuation in exchange rates has had a significant impact on the ways in which the foreign currency transactions are valued and has, as a result, had tremendous impact on collateral obligations, which in turn has had a major impact on the daily management of cash flow within companies involved in those transactions.

Editor: How would that manifest itself from the standpoint of litigation?

Leader: Many companies – and particularly manufacturers – are involved in the regular practice of hedging against their receivables, whether in U.S. dollars or otherwise. They have been trying to work out arrangements with their counterparties to these transactions. But because of the high volatility in the currency market resulting from violent fluctuations in exchange rates, the valuation of credit support obligations under many of these agreements has become very difficult.

We have just started to see some litigation relating to margin calls pursuant to the credit support obligations under ISDA agreements, including disputes related to how margin obligations are calculated and valued. Because of the very volatile market right now and role that volatility plays, there are very wide and disparate valuation data points on many transactions and the credit support obligations under them. That will be the source of significant disputes as this evolves during 2009.

Editor: Do you find the same kind of situation occurring with respect to the Euro and in areas such as Latin America, Eastern Europe and Asia?

Leader: We're seeing a lot of problems related to the global currency markets, particularly in Latin America. The volatility in the marketplace over the last several months is on the extreme end of the spectrum. Many manufacturing companies – particularly in Mexico and Brazil – have been devastated by currency fluctuations because the derivative instruments that were supposed to protect them no longer work. Even if their underlying business is strong, companies have difficulty maintaining the day-to-day cash flow required

to service forward contracts and the credit support obligations related to them.

Editor: Don't banks have a fiduciary responsibility to alert their corporate customers to the potential for loss?

Leader: Given what has transpired over the last few years in the derivatives markets, the issue as to whether banks should have been acting in more of a fiduciary capacity is very interesting and important and one that will see some significant litigation in the U.S. Unfortunately for their customers, the banks have carefully positioned themselves as counterparties only, and to date, courts mostly have upheld the banks' position that they are not fiduciaries.

Allen: I don't think UK law differs enormously. The situations in which a U.S. court would impose or imply a fiduciary responsibility are perhaps broader. The agreements used by the banks are extraordinarily well drafted, as you would expect them to be. In most cases, they will specifically position the bank as counterparty or as a professional client with little in the way of obligations in terms of best execution or otherwise. The deck is stacked against the counterparties to the banks.

Editor: What role do you expect e-discovery to play in this?

Leader: The scope of discovery in the U.S. is very broad, particularly in New York. Of course, the case has to proceed beyond the initial stages to really get into any significant discovery; but, if the cases survive motions to dismiss, e-discovery can take on a life of its own.

Further, the litigation risk, from the perspective of the counterparty banks, is compounded by the fact that the derivatives market has become the subject of regulatory and governmental investigations both in the U.S. and abroad – and these will only intensify as a result of the governmental changes resulting from the U.S. election. The combination of parallel governmental scrutiny and discovery in civil litigation is going to be a significant concern for the banks because it may improve plaintiffs' prospects for litigation success – either through a favorable judgment or settlement.

Allen: Discovery in the UK is somewhat narrower than in the U.S. That's not to say

that you might not have an email that is absolutely on point. That sort of thing could emerge. However, if you're trying to sidestep clearly articulated terms of business, which on the face of it are aggressively not in your favor, you are at significant risk of having your case struck out on a summary basis before you even get to the disclosure process. Procedurally, you could have your legs removed before you even get the chance to have a poke around. There is an ability to seek pre-action disclosure under English law, but I think it is relatively toothless in this scenario.

Editor: As DuPont Primary Law Firms, both Eversheds and Leader & Berkon provide an early case assessment. How does this benefit your clients in the types of cases we have been discussing?

Leader: An early case assessment involves an understanding of the issues, the client's business and the client's business goals in the litigation and generally preparing the client for how the litigation will unfold and its consequences, both in terms of the budget and possible outcomes. It also involves working with the client to develop the litigation strategy. In the types of cases we've been discussing involving the complexities of derivatives transactions, early case assessment is particularly important so that there is a clear understanding at the outset about how the litigation will be handled and its cost and goals.

Allen: I would concur with what Josh has said. There is a lot of emotion around these issues; and, although there is reticence around litigating, when clients get to the point where they're ready to do it, it's usually because they feel very upset about a situation and they're anxious to have a remedy. When there's a lot of emotion and a lot of money at stake, it's very easy to fall into all of the old litigation traps – of embarking on a process, not quite knowing where you're going and how it's going to end up. It's critical in these circumstances to fix an objective and to stay focused and to have a very clear idea right from the outset as to what your best practical outcome will be, how much it's going to cost you to get there, and what the issues are for you commercially. Early case assessment is therefore more important now than it has ever been.