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# Banking and finance disputes review

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## From the editor

In this edition of the *Banking and finance disputes review*, we explore the approach of different jurisdictions to the regulation of banks and their liability to investors and customers. Similar sets of facts raising similar sets of issues arise at varying times in different countries. Comparison of the approach taken by court and regulators suggests how these issues may develop in the future.

Two of our articles compare experiences in the United States and Europe. In *Financial institution crime insurance claims: experience from the US*, we gain valuable insight into issues that may arise in the European banking industry by studying recent American experience. In *Iran sanctions update: Guidance for financial institutions*, we explore the approach taken by the European and American authorities to recent changes in the Iran sanctions regime.

The scope of the obligation of a bank to give information to investors has been the subject of litigation in England and across Europe. The German approach is investigated in *Swap transactions: The scope of German banks' information obligations*. The crucial question of where investors in the capital markets are able to institute proceedings against issuing and arranging banks is considered in our casenote on *Profit Investment v Ossi* (Case C-366/13).

The growing maturity of the French market abuse regime is demonstrated in *Double jeopardy for market abuse in France*. New regulation may sometimes be beneficial to banks – in *The Impact of the EU Trade Secrets Directive on financial institutions* we consider the coming European regime for protection of trade secrets. The new approach to judicial oversight of penalties by the English courts is described in *Genuine pre-estimate and legitimate interests: penalty clauses and financial institutions*.

An increase in activism by bondholders, for some years a feature of the United States capital markets, has led to litigation in England on thorny questions of contractual interpretation. In *A brave new world of noteholder litigation*, we examine arguments deployed by capital markets investors. A contractual interpretation dispute between a bank issuer and retail investors is considered in *Supreme Court confirms approach to construction of bond documents*. Our casenote on *Canary Wharf v Deutsche Trustee* [2016] EWHC 100 (Comm) deals with a contractual interpretation dispute between arranger and investors. A battle over whether the law applicable to a sale of bonds was English or New York was the key issue in our casenote on *Molton v Shooters Hill* [2015] EWHC 3419 (Comm). Our casenote on *JSC BTA Bank v Ablyazov* [2015] UKSC 64 considers the scope of cross-border freezing orders and their applicability to loans.

Finally, please note that these articles were all written before the UK's vote on 23 June to leave the European Union. While it is too early to say anything concrete about how this might affect banking disputes in the UK and elsewhere, for our legal analysis of these fast-moving events, see our Brexit website.



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# A brave new world of noteholder litigation?

## Noteholder litigation in the context of Commercial Mortgage-Backed Securitisation (“CMBS”) transactions is nothing new, whether brought directly by noteholders or via the note trustee.

However, there has been a recent spate of cases brought by CMBS Class X noteholders alleging a miscalculation of the interest due under their notes and claiming all historical underpayments of such interest. These holders have often purchased their instruments relatively recently and at distressed prices and, in many cases, the issue of construction before the court is one that had not previously been apparent to any participant in the structure. In some cases, the relevant events are also so old that a claim for breach of contract would be outside the relevant limitation period. But this limitation period does not apply since the ultimate remedy sought is a declaration of an event of default.

The approach taken by junior noteholders follows a familiar pattern: First, they undertake a forensic analysis of offering circulars and other transaction documents in order to identify potential past errors by transaction parties which could be used as potential triggers for an event of default. Secondly, the noteholder seeks to compel the note trustee to call an event of default, which would cause the transaction to make payments under a post-enforcement waterfall (which is generally considerably more

advantageous for the particular class of notes held by that noteholder). This process is made possible in part because the offering circular and transaction documents are generally available for inspection at the offices of the issuer or note trustee.

### Historical entitlements and standing

In the recent case of *Hayfin Opal Luxco 3 SARL v Windermere VII CMBS Plc* [2016] EWHC 782 (Ch), the claimant (“Hayfin”), a holder of Class X notes in a CMBS, brought a claim against the issuer essentially alleging that there had been a miscalculation of the interest due under its notes and claiming all historical underpayments of such interest. Hayfin ultimately lost the case but, had Hayfin been right, the underpayment of Class X interest (which Hayfin claimed accrued at the Class X Interest Rate) could have potentially amounted to several million euros.

Hayfin acquired its Class X notes in July 2015, and commenced proceedings five months later, in November 2015, claiming backdated interest to July 2007 (i.e. long before it had acquired the notes). Hayfin expressly stated that its

ultimate objective was to trigger an event of default so that the post-enforcement waterfall would apply (under which payments of interest due under the Class X notes were near the top).

A threshold issue that arises in this context is one of standing. CMBS and similar structures typically contain a “no-action” clause against the issuer. This clause prevents any transaction party and any noteholder from instituting proceedings directly against the issuer for non-payment or any other breach of the transaction documents. The aim of this clause is to ensure that it is only the note trustee who may enforce the terms of the notes on behalf of all holders. Typically, these clauses state that a written direction must be given to enforce by a certain percentage by value of noteholders. Even then, the note trustee will usually have no obligation to act unless and until it is indemnified to its satisfaction.

In the Hayfin case, in view of the “no action” clause, the issuer initially challenged Hayfin’s right to bring the claim. In response, Hayfin argued that it had brought a claim seeking a declaration as to the operation of its rights under the notes rather than an action for the recovery of sums. An action for declaratory relief, Hayfin argued, fell outside the ambit of the “no action” clause. As the note trustee subsequently confirmed that it would bring an identical claim on Hayfin’s instructions, were Hayfin wrong on this point, the issuer agreed to not



take the argument further and it was not therefore considered by the Court. However, the question of standing may arise in a more controversial form where the noteholder bringing a claim and the noteholders best placed to direct the note trustee have diverging economic interests.

Hayfin's right to bring the claim was also challenged as it concerned a question of interpretation of an agreement to which neither Hayfin nor the note trustee was a party. Interestingly, Snowden J accepted that Hayfin's claim could legitimately arise in this context albeit with the proviso that the effect of the judgment would not be binding on the parties to that agreement who were not also party to the litigation.

### **When does an event of default occur?**

At the heart of these claims is an attempt to bring a structure into default and invoke the post-enforcement waterfall. Therefore, even if a noteholder can successfully establish a breach of the transaction documents, that breach has to be translated into an event of default - which is incapable of remedy - before the post-enforcement waterfall can be applied. Whether that effect can be achieved is, again, a matter of construction of the transaction documents.

In an important passage in Hayfin, Snowden J remarked that "The [terms and conditions of the Notes] provide an elaborate mechanism for the determination and publication of

the amounts which will become due and payable on the Notes. Important consequences (such as the occurrence of events of default) attach to timely and precise compliance with payment obligations under the Notes, and hence it is consistent with the overall CMBS structure that the payment obligations of the Issuer in respect of the Notes should be defined by those determinations".

While the Court ultimately found against Hayfin on the point of whether there had been a miscalculation and underpayment of Class X interest, it nevertheless ruled that, even if Hayfin had been correct, this would not have constituted an event of default. Hayfin had argued that, if there had been an underpayment on the October 2015 Interest Payment Date, the five day

“cure” period would already have expired and so it would be too late for the event of default to be cured. The Court disagreed. Snowden J took a step back to consider the purpose of a CMBS structure as a whole and expressed that he could not see why the parties would have intended to create a concealed “hair trigger” under which an event of default could accidentally occur because of a simple miscalculation of interest payable, not noticed at the relevant time and yet incapable of cure at a later date, no matter how solvent the structure still was.

The Courts are not necessarily reluctant to declare that an event of default has occurred in the right circumstances. In another recent case, *Citicorp Trustee Company Limited v Taberna Europe CDO II Plc* [2016] EWHC 781 (Ch), in which judgment was handed down on the same day as Hayfin, the Court granted summary judgment on a claim by a senior noteholder that, on construction of the transaction documents, the issuer had breached its obligations thereunder; and, once it had been given notice of such breaches, the noteholder was entitled to accelerate payment of the notes because an event of default had occurred.

## Penalties

The penalty doctrine briefly reared its head in Hayfin on an alternative argument by the issuer that any Class X interest on miscalculations would have been a penalty (the Class X interest rate would have been several thousand per cent). In considering this question, Snowden J applied the principles recently set down by the Supreme Court in *Cavendish Square Holdings B.V. v El Makdessi* and *ParkingEye Ltd v Beavis* [2015] UKSC 67.

According to Cavendish Square, an obligation may be a penalty only if it is a secondary and not a primary obligation. Snowden J did not decide whether the accrual and payment of Class X interest in the event of an underpayment was properly categorised as a conditional primary or secondary obligation, although he considered the point was certainly arguable. Moreover, he did state that the Class X rate was potentially so exorbitant that it could have been out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. There is a reasonable chance, therefore, that, had the judge been compelled to decide the point, he would have ruled that the applicability of Class X interest to any historical underpayments of interest would have amounted to a penalty. This will be of note to transaction parties and those drafting the corresponding transaction documents.

## Conclusion

Hayfin has provided some answers on the specific facts as to the court’s approach to claims brought by the most junior noteholders alleging miscalculation of the interest due under its notes and claiming all historical underpayments of such interest. However, the decision has been appealed (permission to appeal having been granted) and Hayfin has applied for that appeal to be heard on an expedited basis. In a very similar case (Titan Europe 2006-1 P.L.C, Titan Europe 2006-2 P.L.C. Cornerstone Titan 2007-1 P.L.C, and Titan Europe 2007-2 Limited) the court also concluded that there had been no miscalculation of Class X interest (albeit the issues and the wording of the contract were slightly different) and permission to

appeal was refused by the trial Judge (although it can still be sought from the Court of Appeal). It remains to be seen as to whether these decisions will act as a deterrent for noteholders from pursuing further similar litigation.

It is heartening that the Courts are paying close attention to the mechanics and purpose of the transaction as a whole when applying principles of contractual construction. This recognises the important distinctions between cases involving traded financial instruments with the corresponding complex documentation and those that involve bilateral contracts. The commercial purpose of these transactions remains an important line of defence in these claims.

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# Swap Transactions: the scope of German banks' information obligations

Over the last few years, German banks have faced an increasing number of claims brought by German municipalities alleging that those banks breached their obligation to provide information when advising them on swap transactions.

Those swap transactions were typically entered into by highly indebted municipalities and other public institutions, such as health clinics or municipal utilities, in an attempt rapidly to improve their finances. In many cases they suffered significant losses and took legal action against the advising bank. A similar trend has been seen in other European jurisdictions such as Italy and Norway.

The German Federal Supreme Court (*Bundesgerichtshof* – “BGH”) has, in a series of decisions, sought to give guidance as to the requirements for “investor- and investment-specific advice” (*anleger- und objektgerechte Beratung*) in respect of a bank advising on the conclusion of swap agreements. Where a bank arranges a transaction for an investor, it will be deemed to have an advisory role. In bilateral arrangements, where the advising bank is also the counterparty to the swap agreement, the BGH has imposed far-reaching information obligations on the advising bank. Notably, this extends in certain circumstances to a duty to inform about “initial negative market value”. An initial negative market value exists if an investor’s objectively determined profit from the

swap transaction is negative at the moment of conclusion of the contract.

In the 2011 decision of the BGH discussed below, in which the court defined respective information standards for the first time, the court considered a CMS Spread Ladder Swap (a complex structured interest rate derivative using several different types of leverage). In the most recent 2015 decision considered below, the BGH extended those information standards to all swap agreements, even those that were much less complex.

## Judgments of the BGH

### BGH decision dated 22.03.2011, XI (ZR) 33/10

In this 2011 decision, the BGH stated that banks advising on swap transactions have to assess the investor’s ability to bear risks, in accordance with the doctrine of “investor- and investment-specific advice” developed by the BGH. This obligation applies except in the context of long-standing business relationships or if the client’s knowledge of the specific risks of complex swap transactions could be assumed. Even if these exceptions apply, the bank has

to ensure that the client has sufficient knowledge of the associated risks.

Furthermore, the BGH decided for the first time that the bank must inform the investor of an initial negative market value because this constituted a conflict of interests between the client and the bank. The bank also had to disclose to the investor its profits from arranging the underlying risk structure.

However, banks recommending investment products were not obliged to inform their clients that they would make a profit where this was obvious. A disclosure obligation only arose under additional circumstances, such as advising on a swap agreement with an initial disadvantageous risk structure for the investor – that is, an initial negative market value – which created a conflict of interests.

### BGH decision dated 20.01.2015, XI (ZR) 316/13

This case dealt with a Cross Currency Swap. The BGH restated the general principle that a bank had to inform the investor of an initial negative market value since it was an actual, as opposed to merely apparent, and severe conflict of interest which potentially endangered the interests of the investor.

However, on the specific facts, the BGH held that the bank did not have an obligation to inform the investor of the initial negative market value. Although the bank had advised the investor regarding the Cross Currency Swap, it was not the contractual counterparty

to the Swap. Therefore, the BGH did not find any conflict of interests that would have required disclosure to the investor.

### **BGH decision dated 28.04.2015, XI (ZR) 278/13**

In its most recent decision, the BGH has now held that these information obligations apply to all types of swap transaction, because embedding a gross margin into the risk structure (which creates an initial negative market value) is not limited only to more complex swap products. According to the BGH, in less complex swap transactions, there would generally be an acute conflict of interests because the client would not expect a gross margin to be embedded into the risk structure of a swap transaction.

In conclusion, a conflict of interest creating an obligation on the advising bank to disclose an initial negative market value will arise in any kind of swap transaction where the bank is acting as counterparty to the investor.

### **Public Sector Claims**

Where an advising bank has given improper investment advice according to the criteria set out above, it will be liable for damages. The appropriate measure of damages is for the investor to be put into the position it would have been in if it had not entered into the transaction. This compensation is calculated in a particular case by aggregating the investor's concrete profits and losses in connection with the swap transaction, that is, the net amount of payments made and received by the investor.

Claims by German municipalities that engaged in swap transactions have attracted much media interest. Typically, in these cases, the municipalities' treasurers tried to close budget deficits by entering into swap transactions without having properly understood the

risks or at least without having properly taken them into account. The decision makers were not themselves personally liable for the generated losses. Municipal budgets were hugely negatively impacted by these transactions with the consequence that municipalities tried to recover their damages from the advising banks. Given the subject matter, the issue is obviously extremely politically charged within Germany, as similar issues have been in other countries. In fact, the whole episode is somewhat reminiscent of the 1990s swaps litigation in the UK involving its local authorities.

In the meantime, ministerial decrees have been issued defining the extent to which municipalities are permitted to engage in financial derivatives. According to these decrees, a municipality entering into a derivative financial transaction for pure speculative purposes is forbidden. However, management of municipal budgets including borrowing and entering into any kind of financial commitment is part of the core area of self-government of municipalities. This grants municipalities a constitutionally protected status to ensure freedom from the interference of higher administrative bodies. Therefore, to the extent that a swap transaction falls within this protected area, these ministerial decrees bind neither the bank nor its counterparty.

There is also no obligation on the advising bank to inform the municipality's representative of the prohibition on financial speculation by public sector bodies before entering into a swap transaction with the municipality. Most German Courts assume that banks do not provide legal advice to the municipalities and that the municipalities are best placed to determine their own responsibilities. Accordingly, under German law, municipalities are not able to rely on the nullity of a swap transaction caused by their own breach of the prohibition on financial speculation.

Where German municipalities enter into English law governed swaps, the operation of this rule may be unclear. Under English conflicts of law principles, in this situation an English Court would apply German law to determine the capacity of the German municipality but English law to determine the consequences of lack of capacity. Accordingly, an English Court would need to determine whether the rule that a municipality cannot rely on nullity of a swap caused by its own breach of this prohibition falls within the category of rules on capacity or rules on the consequences of capacity, a distinction which is not necessarily apparent within the framework of German law.

### **Outlook**

Municipalities are likely to remain tempted by derivatives transactions and the possibility of using them as an easy reduction of their increasing debt burden. As a consequence, disputes between banks and municipalities are likely to continue. However, the most recent judgments of the BGH should make banks more careful about advising municipalities on derivative transactions and ensure that they give comprehensive information on profitability. This may help reduce the risk of mayors and/or treasurers of municipalities from later bringing claims against the bank.

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# Genuine Pre-Estimate and Legitimate Interests:

## Penalty Clauses and Financial Institutions

On a foggy London morning in November 2015, the UK Supreme Court handed down its highly anticipated judgment on a no less foggy area of the law: penalty clauses. Heard in tandem, the appeals of *Cavendish Square Holdings B.V. v El Makdessi* and *ParkingEye Ltd v Beavis* [2015] UKSC 67, gave the UK's highest court its first opportunity to consider the penalty doctrine in over a century.

Despite concluding that “the penalty rule in England is an ancient, haphazardly constructed edifice which has not weathered well”, the Court unanimously refused invitations to abolish or extend the doctrine, instead choosing to re-cast the test for whether a contractual provision would be considered penal.

This article analyses the key changes to the penalty doctrine flowing from the Supreme Court's judgment, and assesses the potential implications for banks and financial institutions.

### Snapshot

The Supreme Court has abolished the dichotomy between a genuine pre-estimate of loss and a penalty or deterrent, and re-cast the test:

“The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to

any legitimate interest of the innocent party in the enforcement of the primary obligation.”

There are two important outcomes: first, it will now be more difficult to successfully argue that a clause is an unenforceable penalty; second, the commercial interests of the parties, rather than merely the financial implications of a breach, will become a focus of any enquiry as to whether a clause is a penalty.

### Facts

From a share purchase agreement to a parking fine, the facts of the two appeals before the Supreme Court could not have been more different.

#### *Cavendish Square Holdings B.V. v El Makdessi*

Mr Makdessi sold part of his shareholding in a company to Cavendish. Terms of the share purchase agreement provided that

further consideration would be paid to Mr Makdessi at various stages after completion, provided that he did not breach certain restrictive covenants. Mr Makdessi breached the restrictive covenants and, when Cavendish withheld the further consideration, Mr Makdessi argued that the relevant terms were unenforceable penalties.

#### *ParkingEye Ltd v Beavis*

In *ParkingEye*, Mr Beavis parked in a private car park which allowed two hours of free parking but charged a £85 fine if motorists overstayed this period. Mr Beavis overstayed by almost an hour and the managers of the car park, *ParkingEye*, issued the £85 fine. Mr Beavis did not pay and, when sued by *ParkingEye*, argued that the £85 fine was an unenforceable penalty or, in the alternative, not binding by virtue of the Unfair Terms in Consumer Contracts Regulations 1999.

### What is the change?

Prior to the Supreme Court's judgment, the case law had generally led to the position that if a clause was not a genuine pre-estimate of loss, it must be a penalty.

This dichotomy arose, in the opinion of the Court, as a result of an “over-literal reading of Lord Dunedin's four tests” (paragraph 32) in the (previously) leading case of *Dunlop Pneumatic Tyre Co Ltd v New Garage & Motor*





*Co Ltd* [1914] A.C. 79. In an attempt to reformulate the case law before him, Lord Dunedin had suggested the following often quoted factors:

- A provision is penal if the sum stipulated for is extravagant and unconscionable in amount in comparison with the greatest loss that could conceivably be proved to have followed from the breach.
- A provision is penal if the breach consisted only in the non-payment of money and the provision provided for the payment of a larger sum.
- There is a presumption (but no more) that a provision is penal if the same sum is payable in a number of events of varying gravity.

- A provision is not penal by reason only of the impossibility of precisely pre-estimating the true loss.

English Courts (including the Court of Appeal in both *El Makdessi* and *ParkingEye*) had more recently taken steps to mitigate the harshness of the dichotomy by taking into account other considerations such as whether a clause, if not a genuine pre-estimate of loss, is nevertheless ‘commercially justified’. The Supreme Court, however, decided to completely abolish the dichotomy, emphasising that a damages clause may be neither a genuine pre-estimate nor a penalty, or it could be both.

The Supreme Court also disagreed with the related idea that a clause which has some deterrent effect is inherently penal; deciding that there is, in effect,

no difference between clauses which deter and clauses which induce. Both are designed to influence the conduct of the counterparty.

The Supreme Court’s re-cast test considers whether the impugned provision;

- is a secondary obligation;
- which imposes a detriment on the contract-breaker;
- which is out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.

Applying the new test to the cases before them, the Supreme Court held (Lord Toulson dissenting in respect of *ParkingEye*) that the provisions

in question in both *El Makdessi* and *ParkingEye* were not penal (thereby overturning the Court of Appeal's judgment in *El Makdessi*). This was because Cavendish and *ParkingEye* both had 'legitimate interests' in enforcing the primary obligations, with which the detriment imposed by the clauses was proportionate. In *ParkingEye* the Court accepted that there was a legitimate interest in keeping the car park available for shoppers and, separately, in *ParkingEye*'s ability to make a profit from the fines. In *El Makdessi*, the legitimate interest was the party's commercial interests, which in this case were difficult to value.

### What is still unclear?

Two issues come out of this decision which may impact the way commercial parties approach drafting contracts.

Firstly, a determination of what constitutes a "legitimate commercial interest", and whether a contractual provision is proportionate to that interest, can only be determined on a case by case basis. This concept of proportionality tied to the innocent party's legitimate interest is the real paradigm shift in the law. Courts must now consider what, if any, legitimate business interest is served and protected by a given clause, and then consider whether the clause is proportionate to such interest.

Secondly, the Supreme Court confirmed the principle that only secondary obligations (i.e. obligations that are triggered on breach of primary obligations) are capable of being penalties. However, the Supreme Court did not deal in detail with the categorisation of certain clauses as primary or secondary obligations, which is a source of potential uncertainty as evidenced by the Court's split in *El Makdessi* on whether the obligation to sell shares was a primary

or secondary obligation. Whilst careful drafting could be used with the intention of transforming a secondary into a primary obligation, there will always be a risk that a Court will construe such a clause as a secondary obligation, and therefore a potential penalty.

### What does this mean for banks and financial institutions?

The new test sets a higher threshold, which will make it harder for commercial parties successfully to raise penalty arguments, particularly in circumstances where the terms of a contract were negotiated between sophisticated commercial parties of roughly equal bargaining power, who have been legally advised.

When dealing with simple default interest clauses, the bank's legitimate interest will rarely extend far beyond compensation for the breach – in the form of additional interest compensating for any increase in the bank's costs of funding the shortfall – and therefore (as recognised by the Supreme Court) the Dunlop principles (as outlined above) are still 'good law' as to whether a clause is penal. That said, the Supreme Court's recognition that "compensation is not necessarily the only legitimate interest that the innocent party may have in the performance of the defaulter's primary obligations" may provide a means by which a slightly higher rate of default interest may be found to be permissible – if it can be said, for example, that the rate protects the legitimate interest of the bank in ensuring payments are made on time in order to manage its own internal funding arrangements.

Of course, there is a wide spectrum of clauses other than default interest provisions that potentially fall within the penalty rule. In recent years, the English Courts have considered

the application of the penalty rule to clauses ranging from alternative default interest structures (such as a "facility fee" which resulted in enhanced interest being payable if the borrower was in arrears or otherwise in breach of the loan or security terms – see *Aodhcon LLP v Bridgeco Ltd* [2014] EWHC 535 (Ch)), to a provision in an "Upside Fee Agreement" entitling a bank to receive a large fee upon default of a loan in a sale and lease back property financing (see *Edgeworth Capital (Luxembourg) SARL v Ramblas Investments BV* [2015] EWHC 150 (Comm)) and, in the recent decision of *Hayfin Opal Luxco 3 SARL v Windermere VII CMBS Plc* [2016] EWHC 782 (Ch) ("Hayfin"), provisions relating to application of a "Class X Interest Rate" to alleged historical underpayments of interest under a commercial mortgage-backed securitisation structure.

In *Hayfin*, Snowden J – although he did not decide the point – tended to the view that the relevant interest provision did constitute a penalty. As the holder of Class X notes in a commercial mortgage-backed securitisation, *Hayfin* was essentially entitled to the excess monies in the hands of the issuer generated by the structure. The Class X interest rate was then calculated as the relationship between this amount and the principal value of the Class X notes on the relevant interest payment date. In other words, the interest rate bore no connection to contractual interest on monies invested in what the Court termed as the "conventional sense". It was not consideration payable for use of the monies borrowed at a stated rate by reference to the principal amount borrowed and the period of the loan but a sum that was entirely independent of the principal value of the notes. Between 2006 and 2009, the Class X rate varied between 2,700% and 6,001%.

At the time of contracting, the parties could have foreseen that the Class X

rate would have no relationship to the level of damage that would be suffered by the Class X holder in the event of underpayment of interest. Further, the parties also could have foreseen that the application of the Class X rate to any shortfall would be a very large multiple of the unpaid amount every quarter, consequently amounting to a sum that was “many times the amount that would adequately compensate the innocent party for being kept out of its money”. The Court consequently found that the Class X rate was potentially so exorbitant that it could have been out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation.

On the facts of the case, the Court ruled as a matter of construction that Class X interest had not been payable. Also, the Court did not decide whether the accrual and payment of the Class X rate was properly categorised as a conditional primary or secondary obligation so as to bring the penalty doctrine into play. However, if it had been applicable, the Court’s findings strongly suggest that the interest provision would have been deemed to be a penalty.

At this more complex end of the spectrum, Courts (and therefore parties) may take into greater account ancillary commercial factors (such as reputational damage and loss of goodwill, back-to-back contractual obligations, and possibly even incentive payments) in determining the scope of the innocent party’s legitimate interest in performance of the primary obligation.

However, whilst the *El Makdessi* and *ParkingEye* judgments are significant, in practical terms the decision is likely to have a limited impact on how secondary obligation clauses in financing contracts governed by English law will be drafted.

### What to think about?

Whether a party has a legitimate commercial interest (which the clause in question protects) will be measured at the time the contract is entered into (or subsequently amended). It is therefore necessary to consider that point in time when reviewing the provisions of any agreements already in place.

However, it is open to commercial parties negotiating contracts to take a number of steps in light of this decision. If relevant, it may be important to ensure that:

- If a clause is to be effective as a primary obligation, that this is drafted carefully. However, it is worth bearing in mind that drafting alone will not prevent a Court from determining that a clause is a penalty – such a clause must be a primary obligation as a matter of substance, and whether the clause is proportionate to an actual legitimate interest will be a question of fact.
- The commercial justification for the inclusion of such secondary obligations should be recorded and communicated to contractual counterparts. This could be achieved in the contract itself, if not as an operative provision then as a part of the pre-amble or recital, or in a separate side letter. The record should include a description of the legitimate interests and the commercial considerations that led to the negotiated penalty amount. The aim is to fix as much of this background as possible as part of the factual matrix reasonably available to both parties and therefore relevant to contractual construction.
- Again, whilst not determinative, it may be useful to record the parties’ agreement as to the innocent party’s legitimate interests and that

a given clause is proportionate to such interests. This could also be achieved in the contract itself as part of the pre-amble or recital, or in a side letter confirming the other party’s acceptance of the legitimate and proportionate nature of the interest.

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# Supreme Court confirms approach to construction of bond documents

It has been a long journey, albeit an expedited one, for Lloyds Banking Group (the “Bank”) to confirm its right to redeem certain contingent convertible notes (“ECNs”) issued in 2009 as part of a capital raising programme following the financial crisis of 2008. The Supreme Court, in a judgment handed down on 16 June 2016 has, by a majority of 3 to 2, ruled that the Bank was indeed entitled to redeem.

The case has generated significant public and media interest, particularly in view of the fact that a number of ECNs were held by retail investors. This in turn raised interesting questions as to what materials such holders could reasonably have been expected to have in mind and whether such materials could legitimately form part of the factual matrix when construing the relevant clause entitling the Bank to redeem the notes.

## The Enhanced Capital Notes and the regulatory regime

Upon issuance, the ECNs were structured as hybrid or contingent capital (‘co-co’) securities. This meant that, while they were issued as subordinated bonds, if the Bank was unable to meet certain capital adequacy thresholds, they would convert into ordinary shares – the highest grade of loss absorbing capital (or “Core Tier 1 Capital” as it was at the time). In particular, the ECNs were designed to help the Bank pass “stress tests” modelled by the Financial

Services Authority which, at the relevant time (which is to say in the infancy of the stress testing regime), required the Bank to maintain a ratio of at least 4% of risk weighted assets to Core Tier 1 Capital.

In order to satisfy the FSA, the conversion trigger point for the ECNs was set at 5% of risk weighted assets to Core Tier 1 Capital, to allow for a degree of ‘headroom’, by providing for conversion before the then minimum regulatory requirement would be reached.

In 2013, following new EU regulatory legislation, the capital adequacy regime was overhauled by the new regulator, the Prudential Regulation Authority (“PRA”). In particular, the concept of Core Tier 1 Capital was replaced with that of the more restrictive Common Equity Tier 1 Capital (“CET1”). The practical effect of this change was that the conversion of the ECNs could only now trigger if the Bank’s CET1 ratio fell far below the adjusted minimum ratio required by the regulator.

## The main issue in the proceedings

As a result of these regulatory changes, the Bank argued that it was entitled to redeem the ECNs as they had “ceased to be taken into account...for the purposes of any “stress test” applied by the PRA in respect of the Consolidated Core Tier 1 Ratio”. The principal argument put forward at trial and subsequently by BNY Mellon Corporate Trustee Services Ltd, who was representing the note holders as the note trustee (the “Trustee”), was that, for the purposes of construing the wording “ceased to be taken into account”, it was not enough that the ECNs did not in practice help the Bank to pass the stress test hurdle; nor, indeed, to show also that it was now unlikely that they ever would. Rather, the ECNs must in some way be “disallowed in principle” – i.e. the subject of some sort of formal determination by the regulator that they would never be taken into account for the purposes of a stress test, regardless of the inter-relationship between their conversion trigger and the minimum regulatory capital ratio requirement.

In determining this issue, their Lordships considered to what extent, when construing the Trust Deed (which housed the clause entitling the Bank to redeem), it was right to take into account statements in the Exchange Offer Memorandum (the circular for the ECNs), the letter from the chairman of LBG which accompanied the Exchange



Offer Memorandum and the details of the statements and other documents issued by the FSA in 2008 and 2009. These documents demonstrated the importance, from a regulatory perspective, of maintaining regulatory capital at a level above the minimum requirement.

The Bank had announced its intention to redeem the notes on December 16, 2014. The Trustee brought proceedings challenging this claim. After an expedited trial, Etherton C gave judgment on June 3, 2015 in favour of the Trustee. An appeal was then also expedited, resulting in judgment in favour of the Bank by the Court of Appeal on December 10, 2015. The Supreme Court then granted permission to appeal and heard the case, again on an expedited basis, in March 2016. Thus, the entire judicial process, including all levels of appeal, was completed in a year and a half.

### The approach to construction

Lord Neuberger, the President of the Supreme Court, gave the leading judgment and highlighted that the weight given to statements made in other documents available at the time of the contract in question must be “highly dependent on the facts of the particular case”. However, in cases of contracts documenting the terms on which a negotiable instrument are held, he stressed that “very considerable circumspection is appropriate before the contents of such other documents are taken into account”.

The starting point, therefore, for construing such debt instruments is the often cited approach adopted by the House of Lords in *In re Sigma Finance Corp (in administrative receivership)* [2009] UKSC 2. In that case, Lord Collins observed that, where a trust

deed concerned securities issued to “a variety of creditors, who hold different instruments, issued at different times and in different circumstances”, the background or matrix of fact could only be of very restricted relevance in exercises of contractual construction.

In departing from this general principle, however, Lord Neuberger later remarked that, in the Bank’s case, the Trust Deed and the relevant redemption provisions could not reasonably or properly be understood unless “one has some appreciation of the regulatory policy of the FSA at and before the time the ECNs were issued”. This chimes with Lady Justice Gloster’s judgment in the Court of Appeal that the ‘reasonable addressee’ of the Exchange Offer Memorandum had to be taken as “someone having an informed understanding, whether on his own or with the assistance of a financial adviser, of the working of

the relevant markets, the regulatory background, the use of stress tests in the regulator's testing of the adequacy of a bank's capital resources and the function which the ECNs were intended to fulfil".

Having therefore decided to admit the regulator's statements to the relevant factual matrix (along with the other documents referred to above), the next question for the Court was whether the ECNs, in order to be "taken into account", had to play some part in enabling the Bank to pass the stress test as opposed to merely being theoretically taken into account for some purpose in the stress test. In agreeing with the Court of Appeal's approach, Lord Neuberger said that the vital consideration was that, under the new capital adequacy regime, the ECNs could not fulfil the job for which they were designed, i.e. to convert to shares before the relevant ratio was reached. He also remarked that the wording of the clause itself suggested that the words "taken into account" more naturally connoted a dependence upon practical developments than requiring a disallowance in principle before it could cease to apply.

### The dissenting judgments

Lords Sumption and Clarke disagreed with the majority in both their reasoning and conclusions largely on the basis that: (i) the ECNs could still serve their function of boosting the Bank's top tier capital by being converted to equity notwithstanding the change to the minimum relevant requirement; (ii) the concept of a stress test was broader than a simple pass/fail process and the way in which the ECNs might affect a stress test was uncertain; (iii) the most natural reading of the redemption trigger under consideration was that it required the express regulatory disqualification of the ECNs before it could be engaged; and (iv)

the ECNs were long dated securities, which cannot have been intended to be redeemed early except in some extreme event.

### Conclusion

The Supreme Court were faced with two rival interpretations, both of which were consistent with the wording of the clause. In that sense, it was not a contest between a literal interpretation and a non-literal purposive interpretation and the Supreme Court did not try to add further fuel to the debate as to when purposive interpretation is permissible. In fact, Lord Neuberger commented that the Supreme Court had perhaps given too much guidance on contractual interpretation in recent years and his approach is notably free from extensive citation of previous authority. Nevertheless, the decision is an example of a commercial interpretation, taking into account the intention behind the document.

The guidance on taking account of extraneous materials will be helpful in future cases, especially in the case of financial instruments. The Court stressed the importance of starting within the four corners of the document. But when the construction of a clause requires consideration of contemporaneous but extraneous materials in order to be readily understood, these may be admitted for the purposes of the factual matrix. While parties should always aim to include important information in the agreement itself, this shows a commercial awareness by the Supreme Court that was critical in allowing them to determine which interpretation was correct.

There has also been some helpful clarification with regard to what retail investors could have reasonably expected to have understood and

financial institutions will be relieved that the wording contained in circulars stipulating that any decision to invest should only be taken after informed and detailed consideration of the risks surrounding the investment (with the assistance of financial advisors) will be taken at face value by the Courts.

Finally, the narrow majority in favour of the Bank (and indeed the difference of opinion between the court at first instance and the Court of Appeal) shows that these types of contractual construction disputes are not without complexity and consequently capable of dividing opinion at the highest judicial level.

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# The Impact of the EU Trade Secrets Directive on financial institutions

Know-how and information are the currency of our knowledge economy and form valuable assets which need protection. Recourse to conventional intellectual property rights, such as copyright, design right and patents, is not always available for certain technical and business information, such as customer lists, trading algorithms, financial investment strategies, business plans, etc.

With many financial institutions trading across the Single Market, having an effective and as far as possible uniform regime for the protection of trade secrets in place in the European Union (EU) is therefore desirable.

Currently, trade secrets are provided varying levels of protection across the EU. The extent of protection is determined by the laws of each Member State. This is all set to change. In November 2013, with a Proposal for a Directive of the European Parliament and of the Council on the protection of undisclosed know-how and business information (trade secrets) against their unlawful acquisition, use and disclosure (the Directive) the European Commission embarked on a journey to seek to establish a minimum level of trade secrets protection across the EU.

The Directive was not without controversy and it was not until the end of 2015 that agreement was reached. It was essential that the minimum standard should not be too low, so as to ensure that trade secret owners were

given adequate levels of protection and appropriate remedies, but at the same time certain fundamental rights such as freedom of information and freedom of expression had to be protected. Striking the right balance, as well as providing a whistleblowing defence and protecting employees' rights, required some substantive negotiations.

The text of the Directive was finally approved by the European Parliament on April 14, 2016 and the Directive was subsequently adopted by the European Council on May 27, 2016. The Directive has now been published in the Official Journal and will shortly come into force. Member States will have until June 9, 2018 to assess their existing regime and to implement any legislation to comply with the Directive.

## What will change?

The impact of the Directive on individual Member States will depend on the current regime in place. The Directive seeks to provide a minimum level of protection across the EU.

Member States may provide more far-reaching protection, as long as it does not conflict with certain safeguards set out in the Directive.

## A definition of trade secret

The Directive will, for the first time, provide a uniform definition of 'trade secret' across Member States. Article 2(1) of the Directive provides:

“(1) ‘trade secret’ means information which meets all of the following requirements:

- It is secret in the sense that it is not, as a body or in the precise configuration and assembly of its components, generally known among or readily accessible to persons within the circles that normally deal with the kind of information in question;
- It has commercial value because it is secret;
- It has been subject to reasonable steps under the circumstances, by the person lawfully in control of the information, to keep it secret.”

This definition reflects the wording of article 39(2) of the WTO Agreement on Trade-Related Aspects of Intellectual Property Rights (known as the TRIPS Agreement) and is also similar to the definition of trade secret in the US, under the Uniform Trade Secret Act.

A definition should provide banks with a guideline as to what can and cannot



be protected. However, what amounts to “commercial value” or what are “reasonable steps” for information to fall within the definition of trade secrets may not always be entirely clear to banks or indeed national courts. As with any piece of EU legislation, should an issue on interpretation arise in a national court, that court should make a request for a preliminary ruling to the Court of Justice of the European Union (CJEU). It may therefore be some time before judicial guidance is provided leaving, until then, the scope of the Directive, at least at its perimeter, somewhat unclear.

Accordingly, banks should continue to follow the practices of entering into non-disclosure agreements and providing for confidentiality provisions in agreements such as employment contracts.

### **Employees’ skill and knowledge**

The Directive recognises that difficult issues can arise in respect of employees. Where an employee has been employed for a prolonged period of time, the lines between what is the employee’s own skill and knowledge and what is a trade secret belonging to the company can become blurred. The Directive recognises that there is a tension between the two and emphasises in Article 1(3) that trade secrets are protected but experience and skills honestly acquired in the normal course of employment are not. Whether information has been “honestly acquired and in the normal course of employment” is again potentially contentious.

### **Lawful and unlawful acquisition, use and disclosure of trade secrets**

Articles 3 and 4 of the Directive set out what amounts to a lawful and what

amounts to an unlawful acquisition, use and disclosure of trade secrets.

Lawful acquisition, for example, arises when the trade secret is obtained by (i) independent discovery or creation or (ii) observation, study, disassembly or testing of a product or object (made available to the public), as well as a catch-all provision which provides that an acquisition is lawful if it is obtained by any other practice which, under the circumstances, is in conformity with honest commercial practices.

The Directive provides for a fairly broad cause of action where the trade secret has been acquired, used or disclosed unlawfully. For example, in addition to an acquisition of a trade secret being unlawful where there has been “unauthorised access to, appropriation of, or copying of any documents, objects, materials, substances or electronic files, lawfully



under the control of the trade secret holder, containing the trade secret or from which the trade secret can be deduced”, an acquisition of a trade secret is also considered unlawful if there has been “any other conduct which, under the circumstances, is considered contrary to honest commercial practices”.

Use and disclosure is primarily considered unlawful if doing so would be in breach of contract or a confidentiality agreement. Again, national courts may seek guidance from the CJEU as to what “honest commercial practices” means.

Remedies such as interim and final injunctions and seizure orders are all provided for under the Directive.

### Infringing goods

The Directive also creates the new concept of ‘infringing goods’. To qualify as infringing goods, the goods themselves do not need to disclose the trade secret, it is sufficient for example that the goods’ design, characteristics, functioning, production process or marketing significantly benefit from the trade secret (that has been unlawfully acquired, used or disclosed).

Banks can bring an action against persons dealing in infringing goods. Even if those persons do not know that an unlawful use of a trade secret was made, it is sufficient to show that they ought to have known under the circumstances. This could be a valuable weapon in stopping third parties from benefitting from a parties’ valuable trade secrets. However, consideration should be had to the lesser mental state where the defendant ought to have known that it was dealing in infringing goods. A case where the defendant ought to have known but did not actually know that it was dealing in infringing goods will inevitably require disclosure of the trade secret to the defendant, which may not always be desirable. Whether a potential claimant

would want to bring an action under this provision will therefore depend on the circumstances and a weighing up of the pros of receiving redress against the cons of disclosure of the trade secret.

### Maintaining confidentiality at court

A final key feature of the Directive is that it provides for the preservation of confidentiality during court proceedings, helping to avoid the concern that the very case that is brought to protect trade secrets will in itself result in their disclosure. The English Courts for example are already used to hearings taking place at least in part in private to preserve the confidentiality of information. Such procedures are currently not available in all Member States, which will have to adapt to deal with the new provision.

### What will be the impact of Brexit?

The legal landscape after Brexit is still unclear and will remain so for a while. Given the timescale for exit of the UK from the EU, the UK will probably still be a member of the EU before the two year deadline to comply with the Directive has expired.

In any event, the UK’s existing law of trade secrets, which resides in the common law regime of breach of confidence, is in many respects stronger than the protection set out in the Directive and current levels of protection provided in other Member States. If UK lawmakers decide to implement the Directive, notwithstanding a pending Brexit, they may conclude that the UK’s existing trade secrets regime already goes beyond the minimum standard set out in the Directive and may simply choose to adopt the definition of ‘trade secret’ and the concept of infringing goods.

## Conclusion

It will be interesting to see to what extent national trade secret laws will continue to provide an additional layer of protection for businesses. Member States existing regimes, are unlikely to be replaced. This would be welcome in particular where information may not meet the threshold of the definition of trade secret as provided in the Directive.

In the meantime, banks should review their internal procedures to ensure that adequate policies are in place for dealing in commercially sensitive and valuable information. After all, a trade secret is only protected for as long as it is kept secret. Only time will tell whether the scope of the legislation is sufficient to afford adequate protection to businesses in their respective jurisdictions.

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# Canary Wharf Finance plc v Deutsche Trustee Company Ltd [2016] EWHC 100 (Comm)

The issuer of a commercial mortgage-backed securitisation was obliged to pay a premium of £169 million to redeem bonds early in accordance with a ‘Spens’ clause. The judge first applied the natural and ordinary meaning of words used in the contract and then tested this against “commercial common sense”.

## Facts

A valuable property forming part of the portfolio of a commercial mortgage-backed securitisation was sold and the proceeds applied by the issuer to redeem bonds. The issue arose as to whether the prepayment was ‘mandatory’, in which case the bonds were redeemed at par, or ‘optional’, in which case a significant premium of some £169m was payable (a ‘Spens’ payment). The securitisation used a whole-business structure: a special purpose borrower made a loan to companies in the originator group secured by mortgages over commercial property. The borrower financed the loan by an intercompany loan agreement (the “ICLA”) with the issuer, another special purpose vehicle, which in turn financed itself by issuing bonds.

## Decision

Phillips J held that the repayment was optional and so a premium was payable. He cited *Rainy Sky v Kookmin*

[2011] UKSC 50 and also the warning in *Arnold v Britton* [2015] UKSC 36 not to lose sight of the primary importance of the language used in the relevant provisions.

Phillips J then considered the rival interpretations of the relevant terms of the bonds and held that the language was ‘clear and unambiguous’ in pointing to the repayment as being optional, so that a premium was payable. In particular, there was no express requirement to make the repayment – it was something that the issuer could do voluntarily, if it wished to remove property from the securitisation.

The issuer argued, among other things, that it would make no sense for the issuer not to be under an obligation to use proceeds from sale of a property to repay the noteholders – otherwise money could simply sit in the securitisation with the issuer, contrary to the purpose of a securitisation. Phillips J rejected this argument briefly as third in the list of issuer arguments

– even though the issuer had described it as their strongest point. He held that there was an implied term in the ICLA requiring the issuer to use the proceeds to make a voluntary repayment.

Phillips J then dealt with commercial common sense – strictly obiter and for the sake of completeness. He held that the relevant distinction was between repayments arising from matters outside the issuer’s control and those within its control. A premium was required for the latter. Sale of part of the securitised portfolio was within the issuer’s control and so required a premium. The bonds paid a fixed coupon of 6.455% and had a legal maturity of 2033. The rationale for the Spens clause was to ensure that holders were not prejudiced if the issuer chose to redeem some or all of the notes early and was designed to place them in a position they would have been in if the notes had remained in place, by reference to the extra interest the bonds would have earned compared to a risk-free investment return.



## Discussion

The broad question arising from this case is: has *Arnold v Britton* [2015] UKSC 36 made a difference to contractual interpretation or does the judge merely cite it and then do what he would have done anyway? In fact, Phillips J carefully separated the textual analysis from considerations of commercial common sense and decided the case on the former, suggesting a new wariness of over-reliance on commercial common sense.

As to the particular result, one point of weakness is the implication of a term in the ICLA, with limited justification or discussion, imposing a requirement on the issuer to use sale proceeds to repay the issuer. Use of proceeds is one of the key elements of a securitisation, dealt with exhaustively in the priority of payments and elsewhere. So there should be little scope to imply terms of this nature and any implication should follow a thorough analysis.

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# *JSC BTA Bank v Ablyazov* [2015] UKSC 64

## A right to draw down under a loan agreement was included within a freezing order.

### Facts

In November 2009, in long running litigation between the appellant (a bank based in Kazakhstan) and the respondent (a former chairman and shareholder of the bank), the appellant obtained a freezing order against the respondent. It was drafted on the terms of the standard form freezing order contained at Appendix 5 of the Admiralty and Commercial Courts Guide. Between September 2009 and December 2010, the respondent entered into four loan agreements. At the time of the appeal, these loan agreements had been fully drawn down and, at the respondent's direction, substantial amounts had been paid to the respondent's former legal advisors and other third parties.

The appellant made an application for a declaration that the respondent's rights under the loan agreements were included within the freezing order. It argued that they were "assets" for the purposes of the freezing order (among other things). The relevant paragraph of the Order (based on paragraph 6 of the standard form freezing order) provided:

"[The Order] applies to all the respondents' assets whether or not they

are in their own name and whether they are solely or jointly owned and whether or not the respondent asserts a beneficial interest in them. For the purpose of this Order the respondents' assets include any asset which they have power, directly or indirectly, to dispose of, or deal with as if it were their own. The respondents are to be regarded as having such power if a third party holds or controls the assets in accordance with their direct or indirect instructions."

### Decision

The Supreme Court held that the rights to draw down were "assets" for the purposes of the Order. In particular, the respondent's contractual rights in the loan agreements to direct the lender to pay the amounts drawn down to third parties were held to constitute dealing with the lender's assets as if they were the respondent's own, within the meaning of the second sentence of the relevant paragraph. The court considered the relevant terms of the loan agreements, finding that the respondent had an "unfettered" discretion to use the proceeds of the agreements as he wished, including an express power to direct the lender to transfer proceeds to third parties.

The Supreme Court also held that the extended definition of "asset" set out in the second and third sentences of the relevant paragraph (which do not appear in the pre-2002 form of freezing order), extended the meaning of "asset" to assets which the respondent did not own legally or beneficially, but over which he had control. Without the extended definition, the right to draw down under the loan agreements would not be an "asset" under the Order. In considering the meaning of "asset", the court also commented on the application of definitions used in the general law. It held that that while the rights under the loan agreements were likely to be considered "assets" in ordinary legal parlance, "asset" had to be considered in the context of the relevant authorities relating to freezing orders, which did not support the proposition that the right to draw down was an "asset".

The Supreme Court also provided general guidance on construction: freezing orders are "to be restrictively construed", in accordance with the principle that, in view of the penal consequences of breach of a freezing order by the respondent, orders should be clear and unequivocal and strictly construed. It held that the "flexibility principle", the principle that the jurisdiction to make a freezing order should be exercised in a flexible and adaptable manner, had no role in construction; the sole question for the Court is what the freezing order



means. It endorsed the approach taken by the Courts to date, which was to approach construction cautiously, while recognising that the language contained in forms of freezing order has gradually been extended.

## Discussion

This is an important decision for any practitioner in this area. It clarifies that the extended definition in paragraph 6 of the standard form freezing order expands the nature of the assets caught by the order, to assets not owned legally or beneficially by the respondent, including rights to draw down under a loan or other form of credit facility (subject to the precise nature of the rights). As a practical matter, where a respondent to a freezing order is exercising rights under such facilities, he or she must ensure that the rights are exercised in accordance with the terms of the order. For those seeking to obtain and enforce freezing orders, the decision expands the range of assets potentially caught by the order, which (other than loan or credit facilities) might include assets belonging to companies which could be said to be controlled by a director or shareholder.

As a general matter, the Court's guidance that freezing orders are to be restrictively construed highlights the importance of careful and precise drafting in the preparation of orders.

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# *Molton Street Capital LLP v Shooters Hill Capital Partners LLP, Odeon Capital Group LLC [2015] EWHC 3419 (Comm)*

**Contract for sale of bonds was not sufficiently connected to England to displace a presumption that New York law applied.**

## **Facts**

The Claimant, Molton Street, negotiated with the First Defendant, Shooters Hill, to purchase bonds held by a New York hedge fund. Both Molton Street and Shooters Hill were small London-based brokers. Although negotiations were carried out between the two London brokers, Shooters Hill was not sufficiently capitalised to trade as principal on the deals it negotiated. As such it had an arrangement with the Second Defendant, Odeon - a broker based in New York, which meant that for buy and sell transactions negotiated by Shooters Hill, Odeon would step into its shoes as contracting party with the buyer and seller and they would share the profit.

Molton Street was aware of the arrangement between Odeon and Shooters Hill, confirmed the transaction with Odeon and requested a trade ticket from Odeon. Odeon's

emails and trade ticket contained a disclaimer that trades could not be considered "good trades" without express consent of the principals. After being told by its seller that the bonds would not be delivered, Odeon cancelled the contract. This transaction was one of a chain and Molton Street had already contracted to sell the bonds on to Morgan Stanley before it had received them.

Molton Street brought a claim against Odeon for wrongfully terminating the contract and claimed damages together with an indemnity against its liability to Morgan Stanley. The claim against Shooters Hill was compromised and only the claim against Odeon remained to be decided at trial.

A number of issues were in dispute, including the proper law of the contract, which contained no governing law clause. The parties agreed that this issue was to be decided with reference

to Article 4 of Regulation (EC) No 593 on the law applicable to contractual obligations ("Rome I"). Odeon asserted that New York law applied either as the residence of the seller of 'goods' (pursuant to article 4.1(a) of Rome I) or, failing that, as the residence of the party required to effect characteristic performance of the contract, i.e., to transfer the bonds (article 4.2). Molton sought to rely on the "escape clause" at Article 4.3 of Rome I to assert that English law applied as it was clear the contract was manifestly more connected with England.

## **Decision**

Popplewell J did not decide whether or not the bonds were 'goods' under Article 4.1(a), as it was accepted that Article 4.2 would have the same effect. He held that the proper law of the contract was New York law and that the 'escape clause', Article 4.3, did not apply.

Popplewell J compared the test under Article 4 of Rome I with that set out under Article 4 of its predecessor, the Rome Convention, and concluded that

the text and architecture of the two were very different. Under the Rome Convention, in the absence of a choice of law, the test in Article 4.1 was the country with which the contract was most closely connected. Article 4.2 then set out various presumptions to assist with the test, but these were subject to Article 4.5 which provided that the presumptions should be disregarded if “it appeared” from the circumstances as a whole that the contract was “more closely connected” with another country.

In contrast, under Rome I the test is no longer one of closest connection, and is instead contained within the various rules set out in Articles 4.1 and 4.2. The closest connection test has become an “escape clause” to be applied only where it is “clear” that the connection is “manifestly” closer to a country other than determined by the tests in Articles 4.1 and 4.2. Popplewell J concluded that “the new language and structure suggests a higher threshold, which requires that the cumulative weight of the factors connecting the contract to another country must clearly and decisively outweigh the desideratum of certainty in applying the relevant test in Article 4.1 and 4.2.”

In addition to it being Odeon’s place of business, there were considerable connecting factors with New York, including:

- The bonds themselves were closely connected with New York, not England, as they were essentially New York instruments conferring rights against New York trusts.
- The performance of the contract between Molton Street and Odeon was to take place in New York and payment would be made in US

dollars through their respective settlement agents in New York for clearing purposes.

- Following detailed analysis of the transfer of title of the New York instruments through DTC and Euroclear, Popplewell J determined that the delivery of the bonds would take place in New York. If the sale is analysed as an instruction by the seller to its immediate counterparty in the chain of financial intermediaries leading through Euroclear and DTC and a corresponding amendment of the buyer’s interest as against its own immediate counterparty, then there was effectively no transfer between the two – just a separate deletion in one account and addition to another account. However, for the purpose of identifying the place of delivery for the sale, it is necessary to look at the substantive rights attached to the bonds, not the local arrangements whereby instructions are given, and those rights are transferred when the book entry at DTC in New York is changed.
- Little weight was applied to the fact that the negotiations were between exclusively English parties when they were conducted on the understanding that the contract would be with a US party.
- That the contracts above and below the Molton Street/Odeon contract were governed by English law was not a strong connecting factor (although different considerations may have applied if those contracts contained express English governing law clauses). It was “conducive to commercial coherence” for a chain of contracts to be governed by the same law, but, when that governing

law was based on location of the parties or connection with England, trying to apply a single governing law to the whole chain led to conceptual difficulties. This problem would not necessarily apply to a chain where all but one contract contained an express choice of governing law.

Consequently, the remainder of the issues in dispute were decided under New York law and the Claimant’s case was dismissed.

## Discussion

The decision provides useful guidance on the scope of the escape clause under Article 4.3 of Rome 1. It will only be triggered in very limited circumstances, where connecting factors decisively outweigh the choice that would otherwise apply. Although the contract was one of a chain all governed by English law, this was not enough to engage the escape clause – the conclusion might be different if all the other contracts in the chain contain an express choice of English law.

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# *Profit Investment Sim SpA v Ossi* (Case C-366/13)

The ECJ has set out criteria for a jurisdiction clause in bond terms and conditions to bind an investor in those bonds.

## Facts

An investor in credit linked notes argued that the notes were invalid. The terms and conditions of the notes contained an exclusive jurisdiction clause in favour of the English courts. The issuer argued that the investor was bound by the clause.

The notes were issued pursuant to a credit linked note programme using a typical global note structure, under which a global bearer note was held by a common depository on behalf of the clearing systems and investors held their interest via accounts with direct participants in the clearing systems.

## Decision

Article 23 of the 2001 Brussels Regulation (now replaced by Article 25 of the Brussels Recast Regulation, which is the same in all relevant respects) requires an agreement on jurisdiction to be ‘in writing’. The ECJ held that this was satisfied if the subscription agreement between the issuer and the original subscribers for the notes expressly mentioned the jurisdiction clause or referred to the prospectus and that every subsequent sale of the notes did the same.

Article 23 also required the jurisdiction clause to be ‘agreed’ between the parties. By analogy with bills of lading and company statutes, the ECJ held that this did not require a contract directly between the issuer and the investor. Rather, it was sufficient for the clause to be agreed between the issuer and the initial subscriber, the investor to succeed to the same rights and obligations as the initial subscriber and the prospectus to be available to the investor.

Article 23 allows as an alternative to the ‘in writing’ requirement that the clause be agreed in a form which accords with a usage in international trade and commerce. The ECJ held that this was a matter for the national court to determine but set out a number of relevant factors:

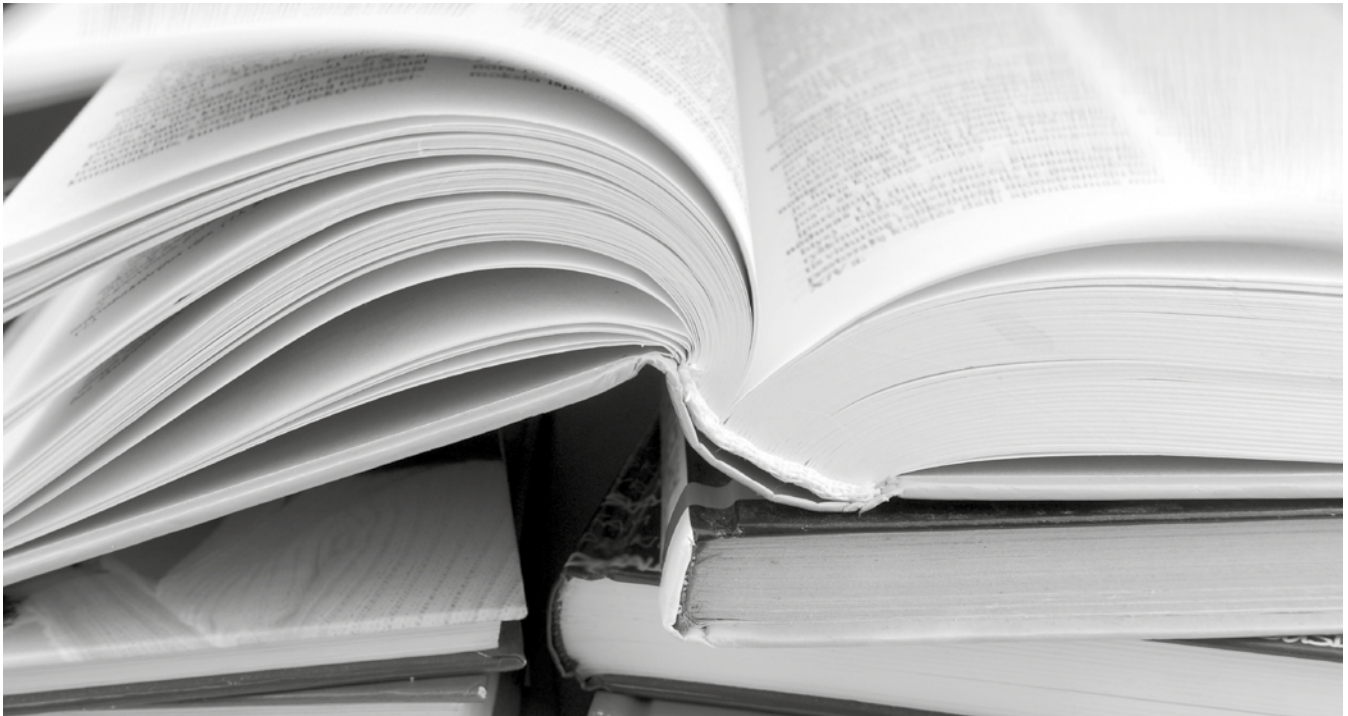
“(i) that such conduct is generally regularly followed by the operators in the particular trade or commerce concerned when contracts of that type are concluded and (ii) either that the parties had previously had commercial or trade relations between themselves or with other parties operating the sector in question or that the conduct in question is sufficiently well known to be considered an established practice.” (para. 51)

## Discussion

In *Kolassa v Barclays*, another case where an investor in Eurobonds took action against the bank issuer, the ECJ allowed an investor to sue an issuer in the investor’s jurisdiction (Austria), on the basis that the investor’s securities account was in Austria and he had suffered the loss there. This was an application of the rules on tortious jurisdiction, as the ECJ held that the issuer had not freely consented to obligations owing to the investor and so the contractual rules on jurisdiction did not apply. This background makes this case doubly important: an effective jurisdiction clause may be the only way to avoid being sued in multiple investor jurisdictions, but the reasoning in *Kolassa* makes it difficult to see how a jurisdiction clause can be said to be agreed between issuer and investor. In particular, in *Kolassa*, the ECJ held that the chain of contracts between the issuer and investor meant that there was no agreement between them for the purposes of the contractual jurisdiction rules. While the test for agreement on a jurisdiction clause is slightly different to the test for contractual jurisdiction, it is still difficult to see how there can be an agreement for the purposes of the former rule but not the latter.

In this case, the ECJ attempted to set out specific requirements for a jurisdiction clause to be effective between issuer and investor. However, it is unclear how their judgment can be applied to bonds transferred in





the European capital markets – the ECJ did not address the complexities of the global note structure and the interposition of common depositaries.

The ECJ held that a jurisdiction clause is ‘in writing’ if it is expressly referred to in every sale contract between the original subscriber and the ultimate investor. However, this does not reflect the realities of bond transfers. Investors are actually transferring interests held indirectly via participants in the clearing systems without extensive contractual documentation.

The alternative of a form that accords with international trade and usage may be more feasible. It will be unclear whether it might actually help until a national court pronounces on the compatibility of jurisdiction clauses with the factors set out by the ECJ.

The more serious issue is with the need for the clause to be ‘agreed’ by the issuer and investor. This is also where the tension lies with *Kolassa*, where there was not the requisite level of

consent for the contractual jurisdiction rules of the Brussels Regulation to apply. The criterion set out by the ECJ is that the investor succeed to the same rights and obligations as the initial subscriber, by analogy with transfers of bills of lading or shares. But an investor in the capital markets typically acquires an interest in a securities account – that is, a bundle of rights against a financial intermediary which itself owns bundles of rights against further intermediaries which ultimately leads to a participant in the clearing systems. The global bearer bond itself is held by the common depositary and interests in it are recorded by the clearing systems (note that there are differences in the nature of those interests depending on whether the note is held using the classic global note structure or the new global note structure).

The result of this complexity is that, on the face of it, an investor in the notes does not succeed to the same rights and obligations as the initial subscriber. Neither the initial subscriber nor the investor are at any point the legal

owner of the notes. The ultimate investor’s interest is likely to be in an account with a financial intermediary entirely independent of the bonds. It is unclear how the ECJ’s criteria for a jurisdiction clause to be ‘agreed’ could be satisfied in practice.

It is to be hoped that future judgments of the ECJ or national courts will clarify how all the criteria set out by the ECJ in this case can be satisfied by investors in the European capital markets.

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# Iran Sanctions Update: Guidance for Financial Institutions

On 16 January 2016, the European Union and United States lifted a wide range of sanctions against Iran in accordance with the Joint Comprehensive Plan of Action (“JCPoA”). Importantly, “Implementation Day” under the JCPoA did not extend to all sanctions against Iran and there remains a mechanism for the reintroduction or “snapback” of the lifted sanctions in the event of Iran not meeting its ongoing commitments to comply with specific nuclear-related measures.

While this first round of sanctions relief may open significant commercial opportunities for EU banks, a number of important sanctions remain in force and US sanctions still generally prohibit “US persons” from engaging in Iranian-related transactions. In practice, the lifting of sanctions will increase the need for robust compliance procedures as global financial institutions navigate the revised EU and US sanctions framework.

## EU Sanctions

The sanctions relief discontinued asset freezes on 34 individuals and 298 entities and has permitted a wide range of trade and associated services in respect of Iran and Iranian persons. Those of particular relevance to financial institutions include relief on precious metals and currency, financial transfers and banking activities and financial services. For more information, see [Box 1].

However, a range of restrictions remain in place post-Implementation Day, including asset freezes on various Iranian persons and various prohibitions relating to nuclear or military material.

Further detailed guidance has been published in respect of the EU sanctions.

## US Sanctions

The United States historically has maintained both primary sanctions, prohibiting US persons from engaging in transactions relating to Iran or involving parties on the List of Specially Designated Nationals and Blocked Persons (SDN List) maintained by the US Treasury Department’s Office of Foreign Assets Control (OFAC), and secondary sanctions, which target the activities of non-US persons. Most of the relief under the JCPoA relates to nuclear-related secondary sanctions. The primary sanctions remain largely in place.

Under the JCPoA, the United States has removed sanctions directed at non-US persons with respect to certain activities. Those with particular relevance to financial institutions include financial and banking measures, insurance measures and gold and other precious metals. For more information, see [Box 2].

The US commitments to lift secondary sanctions do not apply to transactions or activities involving individuals and entities who remain or are placed on OFAC’s SDN List after Implementation Day or to any other US sanctions that may apply under legal provisions other than those cited in the JCPoA.

The United States removed over 400 individuals and entities from sanctions lists maintained by OFAC. Secondary sanctions continue to apply to non-US persons for conducting transactions with any of the more than 200 Iranian or Iran-related individuals and entities who remain or are placed on the SDN List, notwithstanding the lifting of certain secondary sanctions.

In addition, the United States implemented certain limited relief related to the primary sanctions directed at the activities of US persons, including a general license (General License H), authorizing non-US entities that are US-owned or US-controlled, with certain limitations, to engage in transactions involving Iran.

Importantly, many restrictions and/or limitations still apply post-

Implementation Day. Those of particular relevance to financial institutions include primary US sanctions on Iran and limitations for non-US subsidiaries in engaging in Iran-related activities. For further information, see [Box 3].

Further detailed guidance and FAQs have been published by OFAC.

## New business opportunities and compliance challenges

The extent of the sanctions relief is substantial and may pave the way for significant commercial opportunities for non-US financial institutions. From a compliance perspective, banks will need to carefully manage their transition into the new business

environment, given that a number of important sanctions remain in force. For most sectors, the key sanctions to consider will be the asset freeze restrictions, meaning that companies going into Iran will need to carefully screen their proposed counterparties and include appropriate provisions in their contracts. This is important not only in connection with the EU asset freezes, but also the US secondary sanctions, since the relief of these sanctions does not generally extend to transactions involving targets of US asset freezes (Specially Designated Nationals). In the UK, this could perhaps be an area of focus for the new Office for Financial Sanctions Implementation (OFSI), which will be tasked with ensuring that financial sanctions are properly implemented and enforced.

Financial institutions will therefore need to review and update their operating procedures for doing business with Iran to focus on the sanctions still in force. For non-US subsidiaries of US banks proposing to engage in such business under General License H, this task could prove to be somewhat complex, as the provisions and conditions of that Licence will need to be carefully interpreted.

Banking and financial services have been targeted for sanctions relief in the EU and secondary sanctions in the US. While this is welcome to financial institutions, any expansion by them into Iran-related business will require robust and precise procedures to ensure compliance with the remaining elements of the sanctions regime.

### EU sanctions relief

EU sanctions relief effected by amendments to Council Decision 2010/413/CFSP and Regulation (EU) No 267/2012 includes the following areas of particular relevance to financial institutions:

#### Precious metals and currency

Transactions relating to gold, other precious metals and diamonds; supplies of newly-printed or unissued Iranian-denominated banknotes and minted coinage.

#### Financial transfers and banking activities

Financial transfers to and from non-listed Iranian entities; the establishment of relationships with Iranian banks and branches, offices or subsidiaries in Iran; the opening of branches, subsidiaries or representative offices of non-listed Iranian banks in EU Member States.

#### Financial services

The provision of insurance and reinsurance to non-listed Iranian entities; the supply of specialised financial messaging services for non-listed Iranian financial institutions; transactions in public or public-guaranteed bonds with Iranian non-listed entities.

### US sanctions relief

US sanctions relief includes the following areas of particular relevance to financial institutions:

#### Financial and banking measures

Financial and banking transactions related to Iran, including: (i) transactions with individuals and entities set out in Attachment 3 to Annex II of the JCPoA, including, with certain exceptions, opening or maintaining correspondent accounts for the specified Iranian financial institutions; (ii) transactions and other activity involving the Iranian rial; (iii) the provision of US bank notes to the Government of Iran, including providing material support for such transactions; (iv) the purchase, subscription to, or facilitation of the issuance of Iranian sovereign debt, including governmental bonds; (v) the provision of specialized financial messaging services to certain Iranian banks and financial institutions removed from the SDN List on Implementation Day; and (vi) the provision of associated services for each of these categories. The US commitments also include the lifting of bilateral trade limitations on Iranian revenues held abroad, including limitations on their transfer. US persons continue to be generally prohibited under the ITSR from involvement in these activities. In addition, transactions related to these activities are prohibited from transiting the US financial system.

#### Insurance measures

Underwriting services, insurance, or reinsurance in connection with activities consistent with the JCPoA, including activities by non-US persons with individuals and entities set forth in Attachment 3 to Annex II of the JCPoA. The US commitments also include underwriting services, insurance, or reinsurance in connection with activities in the energy, shipping, and shipbuilding sectors of Iran; for certain specified Iranian entities; or for vessels that transport crude oil, natural gas, liquefied natural gas, petroleum, and petrochemical products to or from Iran.

#### Gold and other precious metals

Trade in gold and other precious metals, and the provision of associated services.

Other listed activities relate to sectors such as petrochemical, shipping and automotives.

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## US sanctions after Implementation Day

Certain US sanctions still apply after Implementation Day. In particular, focusing again on those applicable to financial institutions:

### Primary US sanctions on Iran remain in place.

Other than certain limited exceptions provided for in the JCPoA, the US trade embargo on Iran broadly remains in place. US persons continue to be prohibited generally from engaging in transactions or dealings with Iran or its government or with SDNs. In addition, the Government of Iran and Iranian financial institutions remain persons whose property and interests in property are blocked. Absent an exemption or other OFAC authorization, US persons continue to have an obligation to block the property and interests in property of all individuals and entities that meet the definition of the Government of Iran or an Iranian financial institution, regardless of whether or not the individual or entity has been designated by OFAC. Non-US persons also continue to be subject to the US primary sanctions with respect to any action that takes place in the United States (such as US dollar clearing transactions), and there is potential liability for non-US persons engaging in transactions prohibited under primary sanctions if those transactions involve US individuals or entities. US export controls pertaining to Iran also continue to apply to US-origin goods, services and technology, including reexportation by non-US Persons from non-US countries to Iran.

### Non-US subsidiaries still may face limitations in engaging in Iran-related activities.

US-owned or controlled foreign subsidiaries can, with certain limitations, engage in Iran-related business. US persons, however, can have no involvement in the business, except that US persons can be involved in the alteration or establishment of operating policies and procedures of the parent or the foreign entity to the extent necessary to allow the foreign entity to engage in Iran-related transactions and also can engage in activities to make available certain automated and globally integrated systems owned or controlled by the parent. Importantly, General License H does not authorize payment to, from, or through US depository institutions. Any such payments would need to be blocked by the financial institution. This places an important practical limitation on the ability of foreign subsidiaries to engage in Iran business.

Other limitations include continuing US export controls, sanctions targeting Iran's support for terrorism, regional destabilization, human rights abuses and missiles, and secondary sanctions targeting non-US person dealings with Iran-related persons on the SDN List or trade in certain materials involving Iran.

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# Double jeopardy for market abuse in France

The French double prosecution regime of market abuse (criminal and administrative) has been declared unconstitutional by a decision of the French Constitutional Council of 2015, although without relying on the *ne bis in idem* principle. An important reform of the French system for prevention of market abuse is now ongoing as a result.

## Introduction

Administrative regulation of market abuse was introduced in France in 1989 to supplement the existing criminal regulation. This form of regulation was intended to provide an additional specific and appropriate response to market abuse through a dedicated procedure at a time when financial markets were becoming increasingly complex, without detracting from criminal liability.

This solution encountered resistance when it was first implemented for its possible breach of the *ne bis in idem* principle. This is a legal doctrine derived from Roman law to the effect that no legal proceedings can be instituted twice in respect of the same cause of action and is similar to the double jeopardy principle found in common law jurisdictions (the doctrines of *autrefois acquit* and *autrefois convict*). The debate was rapidly resolved after the French Constitutional Council validated the mechanism in 1989 by finding that the

regime was not a breach of the *ne bis in idem* principle.

The European Union has supported this approach of maintaining criminal standards and providing a special procedure to ensure that market abuse is prosecuted efficiently. Indeed, Directive 2003/6/EC (MAD I) required Member States to ensure that appropriate administrative measures and sanctions are implemented. Directive 2014/57/EU (MAD II) restated in its preamble that “It is essential that compliance with the rules on market abuse be strengthened by the availability of criminal sanctions which demonstrate a stronger form of social disapproval compared to administrative penalties”.

More recently however, the *ne bis in idem* principle reappeared before the European Court of Human Rights (ECHR), leading the French Constitutional Council to re-examine the French market abuse regime in 2015.

## The situation before 2015 in France

In 1989, following the *Pechiney-Triangle* insider dealing case, the French Parliament enacted Law n°89-531 aiming at promoting the security and transparency of financial markets. Among other measures, the Law created administrative offences in case of market abuse.

The Constitutional Council (*Conseil Constitutionnel*) was asked to evaluate compliance with the Constitution and decided that the co-existence of administrative and criminal sanctions did not breach the Constitution as they created distinct offences (Decision n° 89-260 of 28 July 1989).

The Constitutional Council also stated that double regulation was acceptable provided that the final penalty that could be imposed by both the criminal court and the administrative body was proportionate, regardless of the fact that a person could be prosecuted in respect of the same facts twice by two different authorities. The final penalty would be proportionate if the aggregate amount of the penalties did not exceed the highest possible penalty.

## The ECHR case law

In 2013, an application was made to the ECHR in the context of the criminal prosecution of a market manipulation offence in Italy.



In its decision, the ECHR noted that the criminal proceedings were based on the same facts for which the applicant had already been sanctioned by the market regulator (ECHR *Grande Stevens / Italy*, 4 March 2014). The ECHR considered that, although the sanctions did not appear disproportionate, both procedures were of a criminal nature, taking into account the severity of the sanctions. As a consequence, the ECHR ruled, on 4 March 2014, that the criminal prosecution should be closed immediately as it breached the *ne bis in idem* principle in accordance with Article 4 of Protocol No. 7 of the Convention.

### The *EADS* case before the Constitutional Council

Articles L.465-1 and L.621-15 of the French Monetary and Financial Code (FMFC), which define market

abuse offences and set out the related sanctions, have been modified several times to increase the powers of the AMF (the French financial market authority) and the amount of potential sanctions (up to €10 million in the 2008 version and €100 million in the current version of these provisions). The compliance of these articles with the French Constitution was challenged during the *EADS* case before the Paris Criminal Court (the parties had already been found not guilty of any misconduct before the AMF sanction committee). For the first time, the challenge was referred to the Constitutional Council (previous decisions had systematically rejected the referral of such requests considering that it had already been settled by the Constitutional Council).

In its decision, rendered on 18 March 2015, the Council, contrary to the ECHR, did not turn to the *ne bis in idem* principle but relied on the principle

of “nécessité des délits et des peines”, that offences should be created and penalties should be imposed only where necessary (Decision n° 2014-453/454 and 2015-462). The Council ruled that, for unregulated persons or entities, double prosecution of market abuse breached this principle since:

- administrative and criminal offences are defined in the same manner;
- both types of offences intend to protect the same social interests;
- the possible sanctions for the offender are of a similar nature;
- judicial courts (that is, those French courts that deal with private law, as opposed to administrative courts) have jurisdiction over both types of offences.

As a consequence, the 2008 version of Articles L.465-1 and L.621-15 was considered unconstitutional and will be partially repealed as from 16 September 2016. In the meantime, where there has been double prosecution, the proceedings with the later starting date, whether administrative or criminal, are invalidated (as in the *EADS* case) and new double prosecutions cannot be started.

Academics have pointed out that this decision of the Constitutional Council is not consistent with European case law, since it uses different reasoning to exclude the simultaneous application of criminal and regulatory provisions. Situations could, therefore, occur where the French system would still allow the double prosecution of market abuse, notably against regulated persons or entities.

## The current legal grey zone

The Constitutional Council recently gave an example of the possibility of a double prosecution.

At the end of 2015, further challenges were made to the constitutionality of other market abuse provisions in the FMFC. On 14 January 2016, the Constitutional Council confirmed that the criteria set out in the *EADS* case apply generally, and consequently ruled that the 2006 version of article L.621-15 of the FMFC did comply with the constitution, since it set out different sanctions for administrative and criminal offences (Decision n° 2015-513/514/526).

As a result, it could be argued that French law does not comply with the *ne bis in idem* principle as interpreted by the ECHR since it allows double prosecution by administrative and criminal authorities in certain circumstances.

By contrast, on 18 June 2015, the Paris Criminal Court (“*Tribunal correctionnel*”) held, in a corruption case related to the Oil-for-Food Programme, that entities or persons could not be prosecuted if they had previously entered into Deferred Prosecution Agreements (“DPAs”) with the Department of Justice (“DoJ”) or the SEC in the United States on the basis of similar facts, relying expressly on the *ne bis in idem* principle. As prosecution by the SEC is similar to prosecution by the AMF, this result is arguably consistent with the standards set out by the Constitutional Council. However, the reasoning is still different, in that criminal courts expressly applied the *w* principle to exclude double prosecution by administrative and judicial authorities.

## Ongoing reform

Given these different decisions, French legislation is necessary to reform the current regulation of market abuse. There are three options for reform.

The first option is to decriminalise market abuse, by removing criminal sanctions or by restricting the application of criminal or administrative sanctions to either unregulated or regulated persons or entities only.

The second option is to create a specific tribunal dedicated to financial markets-related offences. This could be implemented by extending the current scope of competence of the AMF sanction committee to allow it to prosecute criminal offences.

The third option (which has been proposed by the AMF) is to prohibit double prosecution and create a “filter” that would allocate each case either to the AMF or to the criminal authorities. Only the most serious cases (i.e. when a prison sentence appears to be justified) would be referred to the criminal courts.

This third option was partially adopted in a first bill which was presented on 7 October 2015 but never enacted. Then, more recently, a simpler reform was proposed in a bill presented to the National Assembly on 24 March 2016 and scheduled to be examined during Spring 2016. It clearly prohibits double prosecution. It also provides that the choice of prosecuting authority would require prior agreement with the AMF or the Financial Prosecutor. In the absence of agreement, the Paris Court of Appeal would rule on attribution after two months.

These provisions should be assessed in the light of the new anti-corruption law to be adopted soon (Sapin II),

which, among other measures, aims at reinforcing investigatory powers and sanctions against market abuse.

## Conclusion

The French legal framework for the regulation of market abuse will be redefined or, at least, clarified in the next months. One can only hope that it will then comply unequivocally with both European and French case law, in order to end the uncertainty surrounding the prosecution of market abuse in France.

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# Financial Institution Crime insurance claims: Experience from the US

Insurance policies are constantly evolving in response to new and unexpected claims scenarios. In the run-up to every annual policy renewal, there is invariably a wording issue to consider as a result of a novel claim or other development which has happened somewhere in the world. The challenge then is to negotiate a solution which achieves a fair balance of risk between the insurer and the policyholder.

Financial institutions' (FIs) crime or, as they are known in the US, "bond" insurance policies, are no exception to this rule. The general aim of this type of insurance is to provide cover for a comprehensive range of crime-related exposures, including fidelity, third-party fraud and extortion losses. Crime policies are also highly developed, typically encompassing several insuring clauses aimed at providing the cover which FIs require in the face of an ever-changing risk environment.

In spite of their popularity, there is a surprising lack of English case law on crime policies. This may be a function of the fact that FIs and their insurers often prefer to resolve their insurance disputes behind closed doors, by arbitration, in the relatively rare situation where a negotiated solution is not possible. Whatever the reason, the practical result for FIs and their professional advisers is that, from year to year, they do not obtain the benefit of judicial decisions on the scope of crime policies and how they operate.

In order for FIs to understand how their policies might respond, it is possible to look at some recent US cases in this area. These cases are instructive, not only because they provide examples of crime-related losses which have come before the Courts in the past, but also because they give a sense of the factors which may have a bearing on whether a loss is covered (and this applies just as much to jurisdictions outside the US).

## Cheque Fraud

Cheque fraud is often covered under FI crime policies, subject to certain restrictions. While there are a number of variations, at its most basic, cheque fraud involves Bank B encashing a cheque drawn on Bank A, where Bank A has insufficient funds on account for the customer with which to reimburse Bank B. More complex schemes, such as 'cheque kiting' involve multiple accounts at different banks, with cheques passed back and forth between them to cover an underlying

insufficiency of funds, thereby obtaining unauthorised credit.

### *First State Bank of Monticello v Ohio Casualty Insurance Company*

In this case, the bank fell victim to a cheque fraud scheme conducted by an individual over a period of months. The unusual feature of this particular scheme was that the fraudster was not a customer of the bank, which raised money orders for his cheques in breach of its rules. When the scheme collapsed, the bank was left holding worthless cheques with a value of around \$300,000 from the last three days of the scheme. However, when the bank claimed under the "on-premises" insuring clause of its bond policy, cover was denied on two grounds.

The first ground was that the bank's losses did not fall under the "on-premises" insuring clause which covered losses "resulting directly from...false pretenses...committed by a person present...on the premises of the insured while the property is lodged or deposited within offices or premises located anywhere." This was based on a technical argument that on each occasion that a cheque was presented it was a valid and enforceable instrument – it was only when Bank B failed to collect from Bank A that the loss occurred. This analysis was rejected.



The second ground was that the bank's losses did not result "directly from" the fraudster's "false pretenses" and were otherwise caught by an exclusion for "loss caused by an Employee", as a result of the bank's failure to follow its own rules. This argument was also rejected, the Court finding that the fraudster's conduct was plainly the direct cause of the bank's losses, rather than the bank's failure to follow its own rules.

## Fidelity Losses

In one form or another, most crime policies also provide cover for fidelity losses. These are losses which result from the wrongful acts of the FI's own employees, and normally require the policyholder to demonstrate an intent, on the part of the employee, to make an improper financial gain for himself, or for another person with whom the employee has colluded. As a general rule, the insurer will also only be liable for losses which are "discovered" during the policy period. Depending on the bargaining power of the insured, "discovered" can refer to the first date on which (at its narrowest) a particular senior executive first became aware that a claim under the policy was a realistic possibility or (more broadly) when the insured first acquired corporate knowledge of the underlying problem.

### *Resolution Trust Corp. v Fidelity and Deposit Co. of Maryland*

In the *Resolution Trust* case, there were two issues arising from what the Court referred to as a "kiting scheme" conducted by a mortgage lender, Northwest. The mortgage lender's operations had been financed by a loan provided by a warehouse lender, City Collateral (CC), and the scheme involved the diversion of CC's security

and loan repayments. When the matter first came to the attention of certain executives at CC, they decided to suppress it in the belief that, if CC's parent company became aware of the matter, the executives would not be awarded the "golden handcuff" payments which they were expecting to receive. In due course, the matter came to the attention of the parent company but, by this time, the Northwest credit line was in default and CC faced a \$7 million loss. The parent company notified its bond insurer who denied coverage.

The first issue was whether the loss had been discovered during or (as the bond insurer contended) after the policy period. The policy provided that discovery occurred "when the Insured becomes aware of facts which would cause a reasonable person to assume that a loss covered by the bond has been or will be incurred, even though the exact amount of or details of loss may not be known". On this point, the Court decided that this definition should be interpreted widely so that there was a low threshold for discovery and, on the facts of the case, it had been inappropriate to award the insurer summary judgment on the basis that the loss had been discovered after the policy period.

The second issue was whether, for the purpose of the fidelity insuring clause, the City Collateral executives acted with the "manifest intent" to obtain a financial benefit for themselves or a third party which was not a salary, commission, fee, bonus, award or other benefit earned in the normal course of employment – a standard formulation that will be familiar to many FI risk managers. The Court held that the golden handcuff payments (although clearly one-off) fell squarely within the excluded category of benefits that were earned in the normal course of employment. Therefore, the loss was not covered by the crime policy.

### *First Defiance Financial Corporation v Progressive Casualty Insurance Company*

In this case, a bank claimed under its fidelity insurance policy when it emerged that an employee had stolen approximately \$900,000 from its customers' brokerage accounts held with a custodian bank. The bank indemnified the customers and the insurer denied cover.

The first issue was whether, for coverage purposes, the stolen money represented "covered property", in the sense that it was "owned and held by someone else under circumstances which make the insured responsible for the property prior to the occurrence of the loss". The Court decided that it was, rejecting the insurer's argument that the terms of the brokerage agreements were such that the bank disclaimed liability for losses due to breach of fiduciary duty or theft.

The second issue was whether the employee's theft had "directly" caused the bank's losses, because he had stolen funds from customer accounts and not from the bank itself. This was relevant because the policy covered "loss resulting directly from dishonest or fraudulent acts committed by an Employee". The Court held that, because the money was "covered property", and a dishonest employee had stolen it, the employee had "directly" caused the loss. To use the Circuit Judge's words, it was "as simple as that, and that is true under any definition of 'directly'."

The final issue was whether the employee had the sufficient "manifest intent" to cause the bank's loss. Based on previous US case law this objective requirement was met where a particular result was substantially certain to follow from conduct. In the Court's view, there could be no doubt that theft from client accounts in these

circumstances would be substantially certain to cause losses to the bank.

## Counterfeit Documents

In general, most crime policies cover losses caused by an FI's reliance on instruments which are "counterfeit" (meaning, in most cases, a reproduction of an authentic instrument which is intended to deceive) – although cover can be conditional on physical possession of the instrument at the time of reliance.

### *Bank of Brewton v The Travelers Companies, Inc.*

In this case, the bank's bond policy provided cover for loss "resulting directly from" the bank having, in good faith, extended credit on the faith of a certificated security which is "Counterfeit", meaning "an imitation which is intended to deceive and to be taken as an original." Over a period of years, the bank made and renewed a number of loans to a customer for which the customer pledged various assets as collateral. In 2005, the customer assigned a number of shares in a company to the bank in this way, delivering a stock certificate (Certificate 1). In 2009, further shares in the company were assigned and another stock certificate was delivered (Certificate 2). At this point, Certificates 1 and 2 were compared and Certificate 1 was found to be a copy of the original certificate.

However, the customer was able to persuade the company to issue a replacement certificate (Certificate 3) in respect of the Certificate 1 shares. Later on in 2009, the bank consolidated all of the customer's outstanding loans secured, in part, by the previous pledged shares in the company. However, it then emerged that the original Certificate 1 had been delivered to a different bank as collateral for

another loan, meaning that Certificate 3 was void. When the customer was asked to replace the Certificate 1 shares with other collateral, he immediately filed for bankruptcy.

When the bank claimed under its bond policy for its losses in connection with the 2009 consolidated loans, the insurer contended that Certificate 3 was not "Counterfeit" because it was not an imitation purporting to be an authentic document; rather, it was an authentic document that happened to be void when issued. The Court accepted this analysis: while Certificate 3 was fraudulently procured, and as such valueless, it was an authentic document and thus not "Counterfeit". As a result, there was no coverage under the Bond Policy.

## Conclusion

As we observed at the beginning of this article, examples of previous claims are a valuable resource for any policyholder when attempting to assess the scope of a policy. With input from the policyholder's broker on the general claims experience, a legal review which draws on cases from across the world in order to stress-test policies, map out exactly what is covered and identify possible enhancements is an important instrument in the toolbox of any insurance risk manager.

These US cases raise the question whether similar losses would be covered under a crime policy issued in London in 2016. While every policy has its own intricacies, reflecting the particular circumstances of the policyholder and what the insurer is prepared to cover, some general observations are nonetheless possible. For example, in a scenario similar to Resolution Trust, the inducement of a one-off golden handcuff payment might well be fatal to a claim for cover under a standard fidelity insuring clause. As for

First State Bank of Monticello, the "on-premises" coverage in that case is not, to our knowledge, a common feature of crime policies in the London market, although we would be more optimistic about the prospects of recovering the losses in First Defiance Financial Corporation. Finally, with some caveats, cover is often now available for losses arising from the handling of instruments which are fraudulently obtained. As a result, an FI in a similar position to the claimant in Bank of Brewton might have more luck in the UK. Overall, the US cases illustrate the variety of factual scenarios that may need to be considered when evaluating these policies.

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