Insurance/
Reinsurance

January
2013

LIBOR: CONSPIRACY CLAIMS AND THEIR IMPACT ON FINANCIAL INSTITUTIONS AND THEIR INSURERS

In the light of the recent fines levied on UK Financial Institutions (FIs), John Barlow and Karyn Sheridan of HFW and Raymond Cox QC of Fountain Court Chambers consider the ramifications of these developments for FIs and their insurers.

The London Interbank Offered Rate (LIBOR) is calculated daily by the British Bankers' Association, based on submissions made by a panel of 16 FIs in response to the question: *"At what rate could you borrow funds, were you to do so by asking for and then accepting inter-bank offers in a reasonable market size just prior to 11.00 a.m.?"*

Answers are given across 15 maturities in 10 different currencies, with the top four and bottom four submissions discarded. The remaining submissions are then averaged to create LIBOR, and the submissions of all contributing banks are published. LIBOR is then used as a reference rate for £300 trillion of loans and transactions across the globe. An FI's submission reflects its creditworthiness (an FI with an higher rate of borrowing is perceived by the market to be a greater credit risk) which, in late 2007/2008, when inter-bank loans were minimal, was critical to maintain.

Alarm bells began to ring in 2008, when the lack of correlation between LIBOR quotes and FIs' individual pricing of Credit Default Swaps (CDS) became apparent (the pricing of a CDS would have been greater where the FI's cost of funding was above average, reflecting the fact that the FI presented a greater credit risk). Thus, it appears that some FIs depressed the cost of their funding requirements (to give the impression of financial strength) and, on other occasions, increased their LIBOR quotes to increase profits on derivatives, such as interest rate swaps (IRS).

Regulatory investigations commenced in late 2008, culminating in 2012/13 with substantial fines imposed by the Financial Services Authority (FSA) against Barclays (£59.5 million, with a further fine being levied in the US equivalent to £230 million) and UBS (£160 million, $1.5 billion in a combined settlement between UK, US and

Swiss regulators). Reports indicate that RBS will pay a fine in the region of £150 million in the UK.

Individuals may also lose more than just money: a number of directors and officers have lost their positions, and in early December 2012, the Serious Fraud Office (SFO) made the first LIBOR-related arrests in the UK. From the outset, it should be noted that there is a well-documented difficulty in bringing LIBOR manipulation within the scope of any existing criminal offence[1] and the SFO might understandably be reluctant to take a chance, following the high-profile collapse of recent cases.

As with any banking activities with a trans-Atlantic element, litigation has already commenced in the US against 12 FIs, with homeowners claiming that LIBOR manipulation resulted in increased mortgage payments (*Adams et al. v Bank of America Corp. (BAC) et al., 12-cv-07461, S.D.N.Y.*). Larger investment concerns (such as pension funds) are now litigating on the basis they received a lesser return on their investments as a result of LIBOR being depressed (see for example *The Berkshire Bank v Bank of America Corporation (BAC) 12-cv-578 S.D.N.Y.*).

It should not be assumed, however, that a reduction in LIBOR benefitted borrowers. Certainly, those customers with straightforward loans referenced to LIBOR may well have benefitted - however, those locked in to derivative un-hedged contracts, (for example, swaps) where the FIs were the counterparty, may have been significantly disadvantaged.

In this briefing note we consider:

- Conspiracy claims arising from LIBOR manipulation, given the allegations made to date, and the likelihood of those claims succeeding.
- The impact of LIBOR manipulation on IRS mis-selling claims currently being faced by FIs.
- Policy responses.

Conspiracy claims arising out of LIBOR manipulation

Allegations of negligence and/or negligent supervision are likely to feature prominently in any claims. However, the most obvious (and damaging) claims resulting through LIBOR manipulation are likely to be deceit claims, arising out of implied representations as to how LIBOR was, and would be calculated, and how FIs had made and intended to make their LIBOR submissions, as outlined earlier.

Given that a panel of banks submit data required to set LIBOR rates, could a claim be made in conspiracy? Certainly, there have been glimpses of inter-bank collusion. For example, during its investigations, the FSA found that there had been requests for US dollar LIBOR rates made to one FI's submission team, based on communications from traders at other FIs. Consolidated anti-trust proceedings are already on foot in the New York Courts (see *In re: Libor-Based Financial Instruments Antitrust Litigation, MDL No. 2262, S.D.N.Y.*). Could a similar claim based on conspiracy be run in England? The relevant tort would be conspiracy to injure by unlawful means (i.e. in deceit), requiring the claimant to prove:

1. Unlawful action (though the conduct does not need to be actionable at the suit of the claimant).
2. Made pursuant to a combination or agreement between the FI and another person to injure the claimant by unlawful means (however, injuring the claimant does not need to be the conspirators' predominant purpose, this requirement will be satisfied if injury to the claimant is the inevitable 'flipside' of the conspirators' goal).
3. Causing loss or damage to the claimant.

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1. David Corker, 'Manipulating Libor' (2012) 162(7524) NLJ (http://www.newlawjournal.co.uk/nlj/content/manipulating-libor%E2%80%A6).

Whether or not conspiracy claims become a live issue for FIs will depend on, amongst other things, what level of collusion between traders can be established, and whether a combination or agreement, rather than simply isolated requests, can be proved. Equally, claimants will need to establish that the submission of artificially increased or lowered LIBOR figures was unlawful.

The most likely outcome is that conspiracy claims will be rare in practice: claimants would need to prove that the attempts to manipulate LIBOR succeeded, and then show what the outcome would have been had the FI(s) not made misleading LIBOR submissions. This is likely to be an exceptionally difficult task, given that LIBOR is a composite figure, arrived at based on submissions from multiple FIs (who may also have been attempting to manipulate LIBOR in different directions) and arriving at the LIBOR rate involved trimming the highest and lowest submissions. Moreover, given the mechanics of setting LIBOR, establishing a loss and quantum is likely to prove difficult.

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Mis-selling claims and LIBOR

FIs potentially face a raft of new allegations arising out of the alleged mis-selling of derivatives linked to LIBOR. In *Graiseley Properties Limited v Barclays Bank Plc [2012] EWHC 3093 Comm* (a swaps mis-selling claim), Flaux J allowed the claimant to amend its particulars of claim, to add new allegations of deceit against Barclays arising from its involvement in LIBOR manipulation. Relying on regulatory findings against Barclays in the US and the UK, Flaux J held that the new allegations were sufficiently arguable to go to trial.

FIs will have to defend these new allegations of deceit on the facts, and the following issues are likely to arise:

1. What representations were made?
   The claimants are likely to rely on having been given a definition or description of LIBOR in which the FI impliedly represented that it had not previously given false LIBOR submissions or attempted to manipulate LIBOR, and did not intend to do so in the future. The Courts will have to decide what, in each case, a reasonable person in the position of the claimant would infer about LIBOR from the facts of the particular case.

2. Can the requisite fraudulent state of mind be established?
   To prove fraud, the claimant will need to show that the FI knew the representations to be false, had an absence of belief in their truth, or was reckless as to their truth or falsity. They will also need to prove that the FI knew that it was making the implied representation and that it had the misleading sense alleged.

   The difficulty claimants face is that FIs are large organisations and claimants are not allowed to aggregate the knowledge or state of mind of multiple people to establish an FI's fraudulent state of mind (*Armstrong v Strain [1952] 1 KB 232*). To succeed, a claimant will therefore need to identify an individual within the FI whose knowledge and state of mind can be attributed to it, who knew about LIBOR manipulation and knew that products linked to LIBOR were being sold to the claimant.

3. The key question is going to be 'what did senior management know - and do - about LIBOR manipulation?' Flaux J's focus in *Graiseley* on what senior management knew and did about LIBOR manipulation illustrates this point. Thus, there is likely to be a shift from what the parties agreed and understood about the derivative being sold, to questions about senior management's knowledge.

4. Nevertheless, it should be borne in mind that LIBOR manipulation is only one aspect of IRS mis-selling. Critically however, the non-reliance clauses and disclaimers that are such a prominent part of FIs' defences in mis-selling claims are not effective if fraud is made out (e.g. *FoodCo UK LLP t/a Muffin Break v Henry Boot Developments Ltd [2010] EWHC 358 (Ch)*).

Policy responses

So what do these activities mean for FI insurance and reinsurance programmes? The two policies under which insurers can expect notifications of circumstances or claims with regard to LIBOR manipulation are the Professional Indemnity (PI)/Civil Liability (often incorporating a dishonesty extension) and Director and Officer (D&O) policies. Crime/Fidelity/Bankers Blanket Bond (BBB) are unlikely to be impacted, as the FIs do not appear (currently) to have accrued first party losses. Moreover, given the activities, financial benefits will have accrued to the FI. Other policies may have peripheral responses e.g. EPL policies.

With regard to PI/Civil Liability policies, whilst the activities of employees manipulating LIBOR are highly likely to produce third party claims, which prima facie appear to fall within the insuring clause, nevertheless the nature of these activities would appear to trigger a considerable number of policy defences (particularly exclusions), which are to be found in contemporary wordings (older wordings may not possess such comprehensive exclusions, but general issues of moral hazard are likely to arise):

1. Market Abuse (unless the abuse is negligent and committed in good faith, and the burden of proof is expressly placed on the FI to establish this is the case).

2. Some policies exclude violations of the rules and regulations of the Securities Exchange Commission (SEC), or breaches of US security laws. Naturally, there are issues with this and (1) above as to whether the products connected with the LIBOR manipulation are "qualifying investments" (which are traded on a recognised market) or securities which would come under the remit of a regulatory body, such as the SEC or Commodities Futures Trading Commission (CFTC).

3. Claims arising out of the corporate business policy of the FI (which is defined as an activity that is endorsed by two or more members of management and which results in a financial disadvantage to *former or existing customers* of the FI).

4. The termination provision which is triggered when the FI's management becomes aware of the dishonest or fraudulent activities of employees. Cover for that particular employee's activities and claims arising therefrom will be excluded going forward.

5. Actions by the FI's shareholders and bondholders (in their capacities as such) are likely to be excluded.

Older wordings have broader exclusions for deliberate breaches of any laws and, in the absence of a dishonesty extension, express exclusions for dishonest or fraudulent acts. Given the bespoke nature of FI programmes, much will depend on the policy construction as to which exclusions will respond.

In addition, fines and penalties are likely to be excluded (certainly under English law, whether they are civil or criminal fines). However, underwriters do acknowledge that in certain jurisdictions fines and penalties can be indemnified (specifically, underwriters are increasingly giving express coverage for Foreign Corrupt Practices Act (FCPA) fines and penalties insofar

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as they can be indemnified in the relevant jurisdiction). Nonetheless, additional expenditure in connection with establishing structures to ensure that these activities are not repeated under, for example, Deferred Plea Agreements, are unlikely to be covered.

From this perspective, it is difficult to see how PI/Civil Liability policies are likely to respond. On the other hand, it is a different proposition when considering D&O coverage:

1. If the share price is impacted, then derivative or shareholder claims are likely (particularly where FIs have US exposures) (see *Zucker v Rubin (Sup Ct. N.Y.)* on 6 June 2012; and *Vladimir Gusinsky, as Trustee for the Vladimir Gusinsky Living Trust, v Barclays PLC, et al., No. 12-5329, S.D. N.Y* on 10 July 2012).

2. It is highly likely that individuals may be subject to civil (including regulatory and/or criminal claims (and it is clear that FIs will be facing intense investigations from the regulatory authorities in the main global financial centres)). Therefore, D&O policies are likely to respond, to meet legal defence costs and representation costs for inquiries (although such indemnity will terminate on a finding of guilt (and the defence costs which have been paid can (technically) be recovered from the director or officer)).

3. In addition, given that LIBOR issues are likely to have impacted banking activities in London and New York (and elsewhere), regulators may wish to launch criminal investigations of individuals outside their jurisdiction, which in turn could trigger the extradition provisions in D&O policies, for example, for individuals based in the UK.

4. Naturally, how a policy will respond will depend on the programme i.e. whether large Side A limits were purchased, as opposed to a broader distribution of limits, including Side B (with possibly significant excesses) and entity cover.

In short, whilst there are a significant number of issues surrounding indemnification under PI/Civil Liability policies in connection with LIBOR manipulation claims (if current wordings are employed), it is the FIs' D&O policies which are highly likely to be impacted.

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