DERIVATIVES:

PROCTER & GAMBLE v BANKERS TRUST – AN ANALYSIS OF THE HOLDINGS AND THEIR POTENTIAL IMPACT

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On May 8, 1996 US District Judge John Feikens stripped from Procter & Gamble several legal grounds for recovery in its case against Bankers Trust. But critical to note is that these counts were peripheral. The court left intact the essential core of P&G's case – its common law fraud count. In fact, the Order enhanced considerably the strength of P&G's case by finding that Bankers Trust had a duty to disclose material information to P&G even if there were no fiduciary duty.

In summary, the center of P&G's legal position held, Bankers Trust settled on terms extraordinarily favorable to P&G, and (to the extent that there was any doubt) P&G's position in challenging the transactions was vindicated.

Considerable attention is now being focused on Judge Feikens May 8, 1996 order and opinion (the "Order") (*The Procter & Gamble Company v Bankers Trust Company and BT Securities Corporation*, 1996 WL 249435 (S.D. Ohio), 1996 U.S. Dist. Lexis 6435). The Order contains something for everybody and it is human nature to emphasize the positive and view the outcome of an event in the manner most favorable to one's own interests (and this article is perhaps no exception).

The fact that the Order rejected 12 counts brought seeming euphoria to some quarters. One interested party heralded the Order as "an endorsement by the third branch of government" of the sanctity of the swap contract. And the *Wall Street Journal* in its editorial column on May 17, 1996 under a segment entitled "Swaps Defended", referred to "the bureaucrats, enforcers, and other regulatory cowboys" and then wrote:

> "The Feikens decision's main charm is the clarity it brings to the legal status of swaps. In this case, with the regulators taken out of the picture, the parties involved were able within a few hours to wrap up a settlement on the one remaining count of common law fraud that the judge had allowed to stand. Must be a lesson in there somewhere."

Perhaps the lesson is that one should be cautious in accepting what appears in even the most highly regarded newspapers. In fact, the parties agreed on settlement terms the night of May 8 before becoming aware of the content of the Order upon its delivery the morning of May 9. Second, for the numerous reasons indicated below, the Order did not clarify in any definitive manner the legal status of swaps. Indeed, the Order raises new (and, for the dealer community, potentially troubling) issues as to the legal obligation of the dealer to disclose material information "both before the parties enter into the swap transactions and in their performance, and also a duty to deal fairly and in good faith during the performance of the swap transactions".

This article first analyzes the court's holdings and then attempts to place the Order in perspective. As a guidepost to the future, the Order has several significant limitations which will be discussed.

BACKGROUND AND HISTORY OF THE CASE

On October 27, 1994 The Procter & Gamble Company ("Procter & Gamble" or "P&G") filed suit in federal court in Cincinnati, Ohio, its home jurisdiction, against Bankers Trust Company and its affiliate, BT Securities Corporation (together "Bankers Trust" or "BT"). Thereafter, armed with an increasing amount of information acquired through the discovery process, P&G twice, with court approval, amended and expanded its complaint.

In its suit P&G challenged the legal enforceability of two highly leveraged trades, both structured as interest rate swaps. One, the "5/30 swap", was the functional equivalent of a cash-settled option written by P&G and sold to Bankers Trust on the US 30-year bond with the strike price dependent on the yield of the US 5-year note. The dominant feature of this option was its leverage. Here leverage was not simply a stated multiple but rather depended in significant part on the correlation of the movement in the price and yield of these two securities. P&G claimed that BT had the sophisticated models and systems to determine this leverage and thus the true value of the trade which it marketed and sold. P&G alleged, among other things, that this leverage risk should have been disclosed to P&G and that indeed the BT trader had admitted internally that he knew that P&G did not adequately understand the crucial leverage factor.

The second trade, the "DM swap", was structured as a Deutschmark rate swap with its essential element being an option sold by P&G that would be exercised if the four-year DM swap rate broke through a specified band. Leverage was by a stated factor of ten. P&G's central argument here was that BT had provided P&G with false and inflated valuations of the 5/30 swap so as

fraudulently to induce it to enter into the DM swap.

Though their critical component was their optionality, both transactions were structured as swaps with on-going two-way payment obligations. In early 1994, the combined value of these two trades moved, in a matter of weeks, approximately $150 million against P&G.

P&G sought rescission or, alternatively, damages. The core of its suit was its common law fraud count. P&G alleged a number of additional counts which, while not essential, would have facilitated recovery. These causes of action, discussed below, were dismissed by the Order. Further (and not a subject of the Order), P&G asserted that information acquired in discovery and relating to the manner in which Bankers Trust dealt with other counterparties established a pattern sufficient to entitle P&G to relief, including treble damages, under the Racketeer Influenced and Corrupt Organizations ("RICO") Act.

Judge Feikens, a senior US District Judge from the Eastern District of Michigan, was assigned responsibility for the case upon the death in 1995 of the original presiding judge, Carl Rubin. A broad protective order barring public disclosure of confidential information had been issued by Judge Rubin and endorsed by Judge Feikens. This order served, in turn, as the basis for a later order by Judge Feikens restraining *Business Week* from publishing transcripts of alleged tape recordings by Bankers Trust personnel. The US Sixth Circuit Court of Appeals reversed this order as a constitutionally impermissible prior restraint (*The Procter & Gamble Company v Bankers Trust Company et al.*, 78 F.3d 219 (6th Cir. 1996)). However, at the time of writing this article, there continues to be a significant issue as to whether the underlying protective order remains in effect. The content of this article is based exclusively on publicly available, non-confidential information.

In the weeks leading up to the scheduled start of trial, Judge Feikens in open-court hearings requested extensive briefing by the parties on numerous legal issues. He then issued a number of rulings. As to P&G's claim for rescission of the DM swap, the court determined as a factual matter that P&G had failed to act timely after learning of facts which P&G claimed entitled it to rescind and that consequently, as a matter of law, P&G lost any right to rescind the DM swap. This factual premise was sharply at odds with P&G's asserted facts. Nonetheless, this ruling highlights the importance to a counterparty in acting promptly and consistently after learning of facts which would support rescission.

Further, applying New York law and not Ohio law, the court found that P&G was not entitled to recover punitive damages. And as to the RICO action which Bankers Trust had moved to dismiss, Judge Feikens deferred his ruling on the motion. Further, he bifurcated this count, ruling that P&G would first need to prove to the jury fraud by BT against P&G before he would consider allowing P&G to go forward with evidence relating to fraud by BT against other BT swap counterparties.

Then, on May 8, 1996, Judge Feikens issued the Order, dismissing 12 bases for recovery asserted by P&G. These counts consisted of claims based on alleged violations of the federal securities and commodity laws, Ohio securities laws, the Ohio Deceptive Trade Practices Act and counts based on professional negligence, negligent misrepresentation, and breach of fiduciary duty. For P&G these counts were not essential – but they could have been helpful and, in P&G's view, were certainly maintainable. For other counterparties with less compelling facts, these theories of recovery could be crucial.

SUMMARY OF THE ORDER

Questionable Selection of Substantive Law

The court's rejections of the claims based on breach of fiduciary duty, negligent misrepresentation, professional negligence, violation of Ohio state securities laws and the Ohio state Deceptive Trade Practices Act rest on a vulnerable premise. Early in his analysis, Judge Feikens reached a fork in the road: what substantive law should this federal court apply to determine the validity of these claims? A logical candidate for these tort and other claims would be Ohio state law. To determine the applicable substantive law, it is generally held that a federal court in a diversity action is bound by the choice of law rules in the forum state — in this case, Ohio. But, here the court looked to choice-of-law authority under New York state law and a decision by the US Sixth Court of Appeals with regard to Michigan and Alabama state law.[1] There is no indication that the court considered Ohio law as to the effect to be given the contractual choice of New York law in the ISDA agreement. Over P&G's objection, the court then applied New York substantive law to decide the validity of these non-contractual claims.

Another court (in Ohio, Illinois or elsewhere), applying its own conflicts principles, could well limit the ISDA contractual choice of law to contractual claims (resolving any doubts in this respect against the dealer as "the drafter") and conclude that its own substantive law is to be applied to determine these fiduciary duty, state security and other claims – resulting in findings entirely different from those of Judge Feikens.

Applying conflicts principles to determine the appropriate substantive law to be applied to these tort and tort-like claims, Judge Feikens looked to the choice of law clause in the applicable ISDA agreement: "This Agreement will be governed by, and construed in accordance with, the laws of the State of New York without reference to choice of law doctrine."

He stressed the words "without reference to choice of law doctrine" and interpreted this language as precluding the consideration of any choice of law principles, including those relating to tort claims.[2] At least an equally viable argument is that this phrase simply modifies – and does not expand – the opening reference to "this Agreement" and thus is limited to contractual claims. Further, to the extent there is an ambiguity, as a canon of construction, doubt is commonly resolved against the drafter – and here Bankers Trust, a dealer and active member of ISDA, could be viewed as the "drafter" of this ISDA agreement.

Judge Feikens cited in support two cases interpreting New York law, the Second Circuit decision in *Turtur v Rothschild Registry International, Inc.*, 26 F.3d 304 (2d Cir. 1994), and the unreported decision by the US District Court for the Southern District of New York in *P.T. Adimitra Rayapratama v Bankers Trust Co.*, 1995 US Dist. Lexis 11961; 1995 WL 495634; Comm. Fut. L. Rep. (CCH) P26,508 (S.D.N.Y., 1995). But a close reading of *Turtur* suggests that the court there did not separate and distinguish between the governing law clause and, in the following and separate sentence, the submission-to-jurisdiction clause. The court took from the jurisdiction clause the broad language – "any controversy or claim arising out of or relating to this contract" – and imported it into the preceding choice of law provision (26 F.3d at 309, 310). The court offered no explanatory comment for blending these two separate provisions.

Conceivably relevant to the court was that *Turtur* involved an

1 The court cited *Moses v Business Card Express, Inc.*, 929 F.2d 1131 (6th Cir. 1991), *cert. den.* 502 U.S. 821 (1991) which looked to the conflict of laws rules in both Michigan and Alabama (where the case was initiated) for determining the enforceability and scope of a choice of law clause. In this case, the Sixth Circuit then construed a clause not dissimilar to the ISDA clause as requiring the chosen law to be applied to defenses (fraud and misrepresentation) to a contract enforcement action and noting that there the plaintiffs were not asserting a non-contractual claim.

2 *Procter & Gamble*, 1996 WL 249435 at *18.

exclusive jurisdiction clause, but that factor should not have been determinative. The court did not seek to distinguish (or even mention) a line of New York cases holding that a contractual choice of law provision does not extend to tort claims.

In *Adimitra* the court, in the context of an ISDA agreement and submission to the non-exclusive jurisdiction of English courts, followed *Turtur*. This court disregarded the line of conflicting New York cases as "pre-*Turtur*."

Interestingly, even if these two federal cases had properly interpreted New York state law, both were clearly distinguishable in this litigation. Procter & Gamble's inhouse counsel at the outset of the swap relationship with Bankers Trust successfully negotiated deletion of the entire jurisdiction clause (including submission to the non-exclusive jurisdiction of New York courts) from the Bankers Trust ISDA master agreement. Consequently here there was simply no broad language to borrow and import.

It is fair to speculate that, if the case had not been resolved in a manner favorable to P&G, this issue would have been a prime candidate for appeal.

In view of the attention now given to this issue by the Order, counterparties based outside New York may want to consider appropriate language to insert into the ISDA master agreement to clarify that this contractual clause applies only to contractual claims.

Federal Securities Laws

P&G alleged violations of the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and of Section 10(b) of the Securities Exchange Act of 1934 and Rule 10b-5 thereunder.[3]

A threshold issue for Judge Feikens was whether the 5/30 Swap and the DM Swap were a "security" so as to bring into effect the protection of these provisions. These two federal securities statutes contain a substantially identical definition of a "security" and refer to a number of alternative legal instruments which constitute a "security". P&G asserted that the two swaps were a "security" as they fell within one or more of the following specified instruments: an "investment contract"; a "note"; "evidence of indebtedness": an "option on a security or group or index of securities" (as to the 5/30 swap only); and "an instrument commonly known as a security".

Judge Feikens found that neither swap was a "security" based on the following analysis:

(i) **"Investment Contract".** Citing the seminal US Supreme Court case of *SEC v Howey*, 328 US 293 (1946) and later circuit court of appeals decisions, Judge Feikens defined an investment contract as a contract whereby a person invests money in a common enterprise with a reasonable expectation of profits from the entrepreneurial or managerial efforts of others. Judge Feikens found that absent here was the critical element of a "common enterprise" in that the swaps did not involve "the pooling of funds in a single business venture".[4] The fact that BT pooled and managed its risk on a portfolio basis was irrelevant for these purposes. Further, the court found that the value of the swap contracts depended not upon BT's entrepreneurial efforts but rather on market forces and rate movement.

(ii) **"Note".** Judge Feikens rejected the notion that either of the transactions was a "note" within the definition of a "security". First, he stated that "perhaps most basic, the payments required in the swap agreements did not involve the payment or repayment of principal" thus suggesting that they were not "notes".[5]

Nevertheless, he then proceeded to apply the four-part "family resemblance" test set forth by the US Supreme Court in *Reves v Ernst & Young*, 494 US 56 (1989) to be used in determining whether a note is a "security".

1. The motivations of the buyer and seller in entering into the transaction (notes for investment for profit or to raise capital being securities versus commercial notes as non-securities). Judge Feikens, noting that P&G and BT, as counterparties, did not fit neatly into the categories of buyer and seller, found this portion of the test difficult to apply and the result inconclusive.

2. A sufficiently broad plan of distribution of the instrument (common trading for speculation or investment). Noting that P&G could not trade these swaps without the consent of BT and that they were not part of any general offering, the court concluded that the swaps were not widely distributed and therefore did not meet this prong of the test.

3. The reasonable expectations of the investing public. Judge Feikens noted that while some in the media and some commentators might refer to swaps as securities, the relevant perception is not that of the general public but rather that of those who enter into swap agreements. In particular, the court noted that P&G did not initially allege a federal securities law violation, a posture inconsistent with the view that from the outset it considered the swaps securities. Accordingly, the two swaps failed to meet the third prong of the *Reves* test.

4. Whether some factor, such as the existence of another regulatory scheme, significantly reduces the risk of the instrument, thereby rendering application of the securities laws unnecessary. Finding that bank regulatory guidelines in this area were primarily designed to protect banks rather than bank counterparties, Judge Feikens commented that the two swaps might meet this prong of the test.

Balancing the four factors as applied to the facts of this case, Judge Feikens held that the two swaps were not "notes" for purposes of the federal securities acts.

(iii) **"Evidence of Indebtedness".** After commenting that the test here is "essentially the same as whether an instrument is a note", Judge Feikens stated that he was rejecting P&G's argument "in large part because . . . swap agreements do not involve the payment of principal".[6]

(iv) **"Option on a Security or on a Group or Index of Securi-**

3 These federal securities counts did not appear in the original complaint filed on October 27, 1994. On December 22, 1994, the SEC issued its consent order against BT Securities orporation for wilfully voilating federal securities laws in its swap activity with Gibson Greetings, Inc. This order was premised on a finding that the SEC had jurisdiction on the basis that, of the several swaps between Gibson and BT, two were each an option on a security or group or index of securities and thus a "security". P&G alleged federal securities law counts in its first amended complaint filed on February 6, 1995.

4 *Procter & Gamble*, 1996 WL 249435 at 6.

5 Id. at *6. Possibly a currency swap with an initial exchange and then a final re-exchange of principal would be viewed differently – though the court's analysis under the "family resemblance" test would seem to preclude such a swap from being a "note" and thus a security.

6 Id. at *9. Again, this reasoning may not apply to certain currency swaps and such a swap would need to be further analyzed.

ties". P&G contended that the 5/30 swap (though not the DM Swap) was an option on a security or, alternatively, a group or index of securities and thus a "security". The distinction here between a security and a group or index of securities is important in that the statutory language could be construed (as Judge Feikens did construe it) to mean that a cash-settled option on a single security is not a security but a cash-settled option on a group or index of securities is a security. P&G cited the SEC consent Order of December 22, 1994 against BT Securities Corporation.[7] This SEC order contained a finding that the Gibson Greetings-BT "Treasury-Linked Swap" was both an option on a security and, also, (presumably due to the interplay of the 2-year note and the 30-year bond) an option on a group or index of securities and thus a security.

This Gibson Greetings-BT "swap", which was remarkably similar to the 5/30 Swap, was analyzed by the SEC as a cash-settled put option written by Gibson Greetings on the 30-year bond. The differences between this Gibson Greetings swap and the P&G 5/30 swap were insignificant. The strike price on the Gibson swap was determined by the yield on the 2-year note; the P&G 5/30 swap strike price depended on the yield of the 5-year note. The payout on the Gibson swap was lump-sum; payment on the P&G 5/30 swap was spread over four-and-a-half years. Also, as cited by P&G, the SEC was sufficiently concerned that such "swaps" were a security and, as such, would bring into play the broker-dealer registration requirements of the Securities Exchange Act of 1934 that on December 22, 1994 the SEC issued an order (Release No. 34-35135), later extended, exempting from such requirements "individually negotiated, cash-settled OTC options on debt securities or groups or indexes of such securities that (1) are documented as swap agreements" and (2) satisfy the CFTC swap exemption.

Judge Feikens rejected the SEC interpretation and found that "though both the Gibson Greetings, Inc. swap and the P&G 5/30 swap derived their values from securities (Treasury notes), they were not options."[8] The court held that, because the security (the 30-year bond) under the 5/30 swap was not to be delivered but rather cash-settled, it was not an option on a security because there was no statutory provision for cash-settlement as to an option on a single security.

However, Judge Feikens did not address the issue of whether the swap was an option on a group or index of securities. Further, the fact that the payment structure was mandatory (i e the option was self-executing) and, structured as a swap, had two-way payment obligations, precluded it, in Judge Feikens' view, from being an "option".

(v) **An "Instrument Commonly Known as a Security"**. The court noted that the US Supreme Court uses the *Howey* test, in particular the common enterprise element, to determine whether this more general category of security applies. Judge Feikens then noted that he had already determined that the two swaps did not meet the *Howey* criteria. As an aside, he noted that P&G had not initially asserted federal securities laws claims, a position inconsistent with a claim of a security on this basis.

Summarizing and finding that the two subject swaps were not a "security", Judge Feikens took care to comment that:

> "It is important to note that the holdings in this case are narrow; I do not determine that all leveraged derivatives transactions are not securities, or that all swaps are not securities. Some of these derivative instruments, because of their structure, may be securities."[9]

Ohio Securities Laws Claims

P&G asserted three causes of action under Ohio Blue Sky law, all of which required a preliminary finding that the swaps were a "security" as defined under Ohio law. P&G claimed that the swaps were each an "evidence of indebtedness", an "investment contract" or an "instrument evidencing a promise or an agreement to pay money". After extensive discussion, the court concluded that the swaps did not fit within any of these definitions of a "security". The three state security law counts were dismissed on the basis of that interpretation – and on the additional ground that the ISDA choice of New York law precluded recovery under the security laws of another state.

Commodity Exchange Act

P&G alleged violations of the anti-fraud provisions of Sections 4b and 4o of the Commodity Exchange Act and of Section 32.9 of CFTC Rules, 17 C.F.R. 32.9. An ultimate finding in P&G's favor on the CEA counts would have required a preliminary finding by the court that the subject swaps were, as alleged, futures contracts. The court avoided this issue. After finding that both swaps satisfied the criteria of the CFTC swap exemption as set forth in 17 C.F.R. 35.1 and 2, the court then concluded that P&G was not entitled to relief on these bases. Section 4b makes it unlawful for any person, in connection with the entering into a futures contract "for or on behalf of any other person" to engage in certain fraudulent conduct.

Judge Feikens found that BT did not act as agent "for or on behalf of P&G" but rather the parties acted as principals on an arms-length basis.[10] Accordingly, Judge Feikens dismissed this count. Section 4o makes it unlawful for a "commodity trading advisor" to engage in certain fraudulent conduct. Judge Feikens examined the statutory definition of a commodity trading advisor and concluded that it did not apply in that the swaps were not traded on an exchange and, further, that the swaps were exempt under the CFTC swap exemption. The court also examined the facts in light of case authority as to what constitutes a commodity trading advisor and concluded that "while BT Securities came close to giving advice, P&G representatives used their own independent knowledge of market conditions" in making their decision.[11] Regarding Section 32.9, which provides that it is unlawful to defraud or deceive any person in connection with a commodity option transaction, the court examined the competing case law and concluded that "the better reasoned rule of law is that 32.9 is applicable only to CFTC enforcement actions and does not give rise to a private cause of action for [a] violation".[12]

Ohio Deceptive Trade Practices Act

The court dismissed this count without analyzing or interpreting the Ohio state statute. Instead, as indicated above, the court found that the phrase "without reference to choice of law doctrine" in

7 *In the Matter of BT Securities Corporation*, Release No. 33-7124, Release No. 34-35136, Administrative Proceeding No. 3-8579 (December 22, 1994).

8 Nevertheless, the SEC, in a consent order involving a former employee of BT Securities Corporation, has continued to take the view that this Treasury Linked swap was a security. *In the Matter of Gary S. Missner*, Release No. 33-7304, 34-37301, Release No. AE-791 (June 11, 1996), 1996 WL 316296 (SEC).

9 *Procter & Gamble*, 1996 WL 249435 at 12.

10 Id. at *16.

11 Id. at *16.

12 Id. at *17.

the ISDA agreement choice-of-law clause "forecloses the application of Ohio law".[13]

Negligent Misrepresentation
Again the court applied New York substantive law (rather than that of Ohio, the jurisdiction where the alleged tort impacted and occurred). Presumably this decision was again based on the ISDA choice-of-law clause. Based on a line of New York cases, Judge Feikens found that to recover on the basis of negligent misrepresentation a party must preliminarily establish a "special relationship of trust and confidence". Judge Feikens then held that where, as here, sophisticated corporations deal on a business level, no such relationship exists.[14]

Professional Negligence
P&G had urged the court to apply Section 299A of Restatement (Second) Torts, which provides in relevant part that, unless otherwise represented, a party who undertakes to render services in the practice of a profession or trade is required to exercise the skill and knowledge normally possessed by members of that profession or trade in good standing in similar communities. Again applying New York law, Judge Feikens found that New York cases had rarely applied this section and he too declined to do so. Instead he pointed to the duties and obligations of Bankers Trust under the implied duty of good faith and fair dealing (discussed below) and stated that where, as here, the rights and duties of the parties are based in contract, this implied duty renders a negligence claim redundant.

Breach of Fiduciary Duty
Judge Feikens stated that "New York case law is clear" on this issue.[15] He did not state why he was applying New York (rather than Ohio) substantive law to decide this point. Presumably (but not necessarily correctly), he was again relying on the ISDA master agreement choice-of-law clause. After quoting case authority to the effect that in New York no fiduciary relationship can exist where the two parties were acting and contracting at arm's length or between parties to a business relationship, the court noted that "P&G and BT were in a business relationship" – and therefore no fiduciary duty was owed by BT to P&G.[16] However, importantly the court then made a finding rendering the fiduciary duty issue largely irrelevant here and which would have significantly facilitated the case for P&G had the litigation not been settled.

"Superior Knowledge" – Duty to Disclose
While the Order dismissed numerous of P&G's claims, Judge Feikens strengthened considerably the core of P&G's case. Judge Feikens found that under New York law the agreement between the parties contained an implied covenant of good faith and fair dealing which, in turn, imposed a duty on Bankers Trust to disclose material information. Here – unlike the dismissed tort and Ohio state law claims – the application of New York law appears entirely appropriate. That is because the court was construing a contract which provided that it was to be "construed and enforced" under New York law. In his Order, Judge Feikens states:

> "I conclude that defendants had a duty to disclose material information to plaintiff both before the parties entered into the swap transactions and in their performance, and also a duty to deal fairly and in good faith during the performance of the swap transactions."

What triggers this duty is not entirely clear. Judge Feikens started the discussion of this issue by citing the Second Circuit decision in *Banque Arabe et Internationale D'Investissement v Maryland National Bank*, 57 F.3d 146 (2d Cir. 1995) and stating that an implied contractual duty to disclose in business negotiations "may arise where: (1) a party has superior knowledge of certain information; (2) that information is not readily available to the other party; and (3) the first party knows that the second party is acting on the basis of mistaken knowledge".[17] This language was adopted by Judge Feikens practically verbatim from the cited Second Circuit case (id. at 154).

Establishing the third element could be especially challenging, particularly if "clear and convincing evidence" is required. It is unclear whether Judge Feikens considered the third factor as essential given his further comments on the issue. He stated such a duty to disclose "may arise when one party to a contract has superior knowledge which is not available to both parties". Shortly thereafter he commented that "[e]ven though a fiduciary duty may not exist between the parties , this duty to disclose can arise independently because of superior knowledge". Again, no mention was made of the third criterion above. Also, Judge Feikens cited in support three cases interpreting New York law, none of which stated that proof of such knowledge is required for recovery.[18] However, important to note is that the Second Circuit did specifically address this issue and found that "[s]uch knowledge is a prerequisite to a duty to disclose based upon superior knowledge and is therefore an indispensable element of Banque Arabe's claim" (id. at 156).

The upshot of all this was that, if the case had gone forward, P&G would have been able to establish a common law fraud case based on the breach of a duty to it to disclose material information. Although in another case this issue might be raised in the context of a claim for breach of contract, here because of the posture of this case the breach of this duty would only have been asserted as part of the fraud claim.

Again, this is a decision by a single US district judge on a specific set of facts where the issues immediately became moot and were not appealed – but for many Judge Feikens reasoning and analysis of New York law will seem persuasive. As noted above, as to this issue the application of New York law appears entirely correct – unlike with many of the other dismissed counts.

Numerous issues arise. At what point does knowledge become "superior"? Is this primarily a function of two variables: complexity of the product and the relative sophistication of the parties? The court specifically found that P&G was "sophisticated". Yet, the level of complexity resulted in "superior knowledge" on the part of the dealer. Conversely, could a counterparty be so unsophisticated that a generic swap could trigger the obligation to provide material information? And, is the relevant sophistication that of the institution as a whole or that of the contracting individual?

If applicable, what does "not readily available" mean? Does availability from third parties suffice? If so, is the reasonableness of cost a relevant factor? How can the duty be satisfied? What is "material information"? Can the duty be contractually negated? What is the effect of the current ISDA-sponsored non-reliance representations? Would end-users expressly agree that a dealer with superior knowledge need not disclose material information to the end-user?

Further, if in the future a court applying New York substantive law does require here a showing that the party with superior

13 Id. at *18.
14 Id. at *21.
15 Id. at *19.
16 Id. at *19.
17 Id. at *20.
18 *Young v Keith*, 112 A.D.2d 625, 492 N.Y.S.2d 489 (N.Y.A.D.3 Dept.1985); *Haberman v Greenspan*, 82 Misc.2d 263, 368 N.Y.S.2d 717 (N.Y.Sup.1975); *Allen v West Point Pepperell, Inc.*, 945 F.2d 40 (2d Cir.1991).

knowledge knew that its counterparty was "acting on the basis of mistaken knowledge", the end-user could be faced with difficult problems of proof. This would be particularly so if the claim were based on fraud with its "clear and convincing evidence" standard and, further, if proof of actual (rather than constructive) knowledge is required.

Placing the Order in Perspective

The Order is helpful in that it is the first written holding by a judge in the United States to address the broad range of legal issues challenging the enforceability of swap and related transactions. However, there are several factors to consider in determining its future relevance.

Not Binding

The Order was not an action with far-reaching authority and effect, such as a decision by the US Supreme Court or legislation enacted by Congress. In fact, this Order by a single US District judge is legally binding in one and only one case – and that case has now been settled and dismissed. Even if the decision is officially published, future courts, including even in the Southern District of Ohio where the Order was rendered, will be free to accept or reject Judge Feikens' reasoning.

Not Tested

Another court, in deciding whether or not to adopt this court's analysis, will undoubtedly note that these legal conclusions were not tested on appeal – and may also note that in the one instance in this case where a decision by this court was appealed (prior restraint of publication by *Business Week* of sealed documents), the federal Sixth Circuit Court of Appeals not only reversed but sharply criticized the legal findings.

Rejection of Expert Regulator Analysis

Another court might view the Securities and Exchange Commission as well positioned to determine whether a particular structure is an option on a security or group or index of securities and thus a "security – and then defer to (rather than, as here, disagree with) the SEC's conclusions in that regard.

Limited Scope

Judge Feikens himself stressed that his decision, particularly with respect to the federal securities counts, was limited to the facts of this case and that some swaps, "because of their structure, may be securities". However, his reasoning of "no security" would seem to apply to all but the most exotic trades.

P&G Unique

The findings regarding fiduciary duty, commodity trading advisors and others were made against Procter & Gamble. But, P&G, one of America's corporate giants, is among a small class. Few end-users have annual revenue in excess of $30 billion or the accompanying level of sophistication. Another court with another end-user counterparty might reach other conclusions on these issues.

Questionable Choice of Substantive Law

As noted above, the selection of the substantive law applied to the claims for breach of fiduciary duty, negligent misrepresentation, professional negligence, violation of Ohio securities laws and the Ohio Deceptive Trade Practices Act appear subject to serious challenge. If, as seems plausible, another court were to apply local state law, rather than New York law, the resulting ultimate conclusions could differ considerably from those in the Order.

State Security Law Claims

This court dismissed the state security claims on the dual grounds of statutory interpretation and the contractual choice-of-law clause. As suggested above, another court could well disregard the notion that the ISDA clause displaces the protection of its own state securities laws (particularly if the local state division of securities has become involved) and could then proceed to interpret its statute to determine whether the subject trade is a "security". There was no suggestion or finding that in this respect federal law in some manner pre-empted state law. Risk under state securities laws should not be entirely disregarded, particularly as to more exotic trades.

VINDICATION OF PROCTER & GAMBLE

P&G has a corporate culture known to emphasize integrity. As to litigation, this consumer-products giant (and potential target defendant) has a well-established reputation for being fair but tough. P&G had the determination and the resources to pursue its convictions to the end. And it appeared clear from Judge Feikens' prior comments that, while he might clear away the underbrush and simplify the case for the jury, he was going to allow the case to go to the jury on the fundamental fraud count. While the content of the Order was not known until after an agreement in principle to settle had been reached, its substance should not have been a surprise in view of a number of comments by Judge Feikens in open court in the weeks leading up to the Order.

Judge Feikens noted in his Order that "BT claims that P&G owes it over $200 million". With a trial date fast approaching, Bankers Trust agreed to settle this claim by receiving the sum of $35 million. In addition, the parties agreed to the cancellation of a third "plain vanilla" swap under the master agreement which when earlier "terminated" by BT had a close-out value to P&G of approximately $14 million but had, as of April 1996, declined to about $4.8 million. Also, it was agreed that P&G would retain the approximately $4.1 million it had received under the two disputed swaps. These terms, overwhelmingly favorable to P&G, presumably reflect the well-advised parties' views as to the relative merits of the case. As such, the settlement can be viewed as a recognition of the correctness and propriety from the outset of Procter & Gamble's challenge of these trades. ❐

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