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-**

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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.