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LIBOR Manipulation

The implications for all financial institutions

Executive Summary

This note considers some of the implications for financial institutions that have LIBOR-linked assets and/or liabilities. This is the first of a series of notes that we will be publishing in connection with this fast-developing topic, where the landscape continues to shift on a daily basis. This note explores:

- who are the potential claimants - including institutions that were "long" LIBOR during the relevant periods
- potential defendants - the position of banks that are shown to have manipulated LIBOR; and also those innocent banks that have benefited from distortions in LIBOR
- causes of action and loss calculations - including the question of whether losses must be netted against gains arising from LIBOR manipulation
- limitation periods - both domestically and where contracts are subject to foreign law

Introduction

The general consensus as to Barclays' recent admission of systematic LIBOR fixing over a number of years is that this will almost certainly prove to be the tip of the iceberg. Indeed, Barclays' own recent internal memorandum on the issue effectively sought to reassure staff that the constant barrage of criticism would lessen as other banks' roles in the scandal came to light. Press reports suggest that a significant number of other banks are already under investigation (Lloyds, UBS and The Royal Bank of Scotland are all reported to be facing FSA sanctions) and a full parliamentary enquiry in the UK as been announced. With the fallout from the crisis beginning to take shape, we have been considering the issues that potential claimants will need to address should they wish to mount a successful action against a bank in such unprecedented circumstances.

Broadly, there are two time periods where Barclays admitted that it had attempted to manipulate LIBOR. The first was the period between January 2005 – July 2008 (the "First Period") and the second was between approximately mid 2008 – May 2009 (the "Second Period"). It is the First Period that is of particular interest, given that the attempted manipulation occurred against a backdrop of steady economic growth and was attributable solely to the banks' greed. The banks' motives for manipulating LIBOR during the Second Period may be deemed slightly more acceptable owing to the unprecedented economic turmoil at the time, and the perceived pressure from the Bank of England on those banks not to submit high rates, which could cause panic as to the banks' solvency at a time of crisis.

Who are the potential claimants?

At its simplest any party that has an income linked to LIBOR is a potential claimant. These would include, in particular, institutions that invested in floating rate securities with a LIBOR benchmark, or were floating rate receivers under an interest rate swap or other derivative. Moreover, certain types of interest rate derivatives will have featured a "knock-in" provision by reason of which one party may have found itself paying a punitive fixed rate of interest when LIBOR fell beneath a pre-determined floor.

Who are the potential defendants?

At this stage, there appear to be two main targets:

1. banks eventually shown to been involved in the manipulation of LIBOR; in particular, Barclays for whom much of the incriminating material is already in the public domain; and

2. banks that are not implicated in the manipulation of LIBOR levels.

Claims against LIBOR-manipulating banks are clearly going to be easier to establish than those against banks that are not implicated. If you had entered into a LIBOR-linked contract with a bank that had no involvement whatsoever in the LIBOR scandal (for example, it didn't form part of the panel of submitting banks) then the position is less clear. Certainly, you may be worse off, and the bank, although innocent, is likely to be better off. However, the reason such a position has arisen is because the LIBOR index that underpinned the entire arrangement was exposed as being rigged. It will be worth exploring the possibility that the bank has been unjustly enriched as a result of the LIBOR manipulation, albeit that the bank in question may have been innocent. Any innocent banks that do find themselves being sued on this basis may well seek to recover any losses that they suffer from the manipulating banks.

Causation

A key hurdle to overcome in all of these potential cases is that of causation – i.e. demonstrating that the banks' actions in manipulating LIBOR caused loss. This causal link will not be straightforward owing to the method used in calculating LIBOR. To do this, numerous submitter banks make daily submissions at 11am GMT, and those submissions at either end of the spectrum are excluded, with the average of the remaining submissions forming the LIBOR level for that day. If the claimant is unable to demonstrate a causal link between the banks' actions and the claimant's loss, then the case will fail.

A further obstacle will be seeking to establish what impact, if any, a particular bank's artificial submission had on the overall level of LIBOR. Of course, this assumes that there were no other banks involved – if there were, and it can be shown that there was collusion as regards the LIBOR submissions, then more than one bank submitting artificial figures with a similar aim is more likely to have an impact on the final LIBOR figure. However, by way of hypothetical example, if a bank wanted a low LIBOR level so as to make significant gains, then if that bank were less than honest, it is likely to submit a low figure. There is, of course, a risk (from the dishonest bank's perspective) that its submission may be at the extreme end of the spectrum of LIBOR submissions (and so will be disregarded for the purposes of the overall LIBOR calculation), but if that bank submitted a low rate on 10 consecutive days, and it only 'worked' on one occasion, that bank is still doing all it can to skew the odds in its favour on each day. Even if their submission is excluded, they will not have suffered loss as a result; the LIBOR level will not have risen by virtue of their submission. It is, in a sense, heads the bank wins, tails the bank draws.

One option that is being given increasing consideration in circumventing the need to demonstrate a causal link is an argument that, by virtue of the LIBOR level having been manipulated, any transaction that was linked to the LIBOR level was void or voidable from the outset, and is liable to be rescinded. The argument is essentially that it was an implied term of any such contracts that LIBOR was legitimately calculated – recent developments place serious doubt as to the integrity of the rate and accordingly, if successful, the entire contract is unraveled.

Losses

The measure of loss is, of course, contingent on the underlying cause of action of which there are many potential candidates. These include, but are not limited to, contractual remedies, tortious relief (in particular, fraudulent misrepresentation), unjust enrichment, conspiracy and anti-competitive behaviour. However, there are a number of overarching, general considerations:

Valuing the Claim

Whilst the affected parties are likely to have an idea as to which contract(s) were loss-making (as a result of a lower LIBOR-linked return) there is likely to be a need for detailed forensic exploration. As a crude measure of loss, a party should seek to establish the position it would have been in but for the bank manipulating LIBOR. This will inevitably involve a degree of speculation as to what LIBOR should have been on the relevant date(s). There appears to be more than one way of seeking to establish this:

1. Remove the "manipulating" banks from the LIBOR equation altogether – albeit that if more banks become embroiled in the scandal, as is widely expected, then the remaining pool of innocent banks would shrink (potentially dramatically); or

2. Seek to establish what all of the "manipulating" contributor banks' submissions ought to have been and re-calculate the LIBOR levels on this basis. Again, this will not be a straightforward task. Nevertheless, it is to be expected that each of the LIBOR panel banks had some sort of methodology for determining what LIBOR levels to submit on a daily basis and so, in theory, it should be possible (although painstaking) to "re-create" what those submissions should have been on any particular date.

There may be methods of avoiding this thorny issue. A claim under competition law might provide the solution, on the basis that the banks' conduct had the effect of preventing, restricting or distorting competition. There may also be scope for a claim based on "gains based damages" where, rather than the claimant being asked to demonstrate the loss it has suffered, the emphasis switches on the bank to demonstrate what it has gained.

Whichever method is adopted, it is expected that there is likely to be considerable market debate on this topic.

Where the potential claimant has both benefited and lost out as a result of the manipulation

Whilst some potential claimants will have only had positions that caused them loss as a result of the LIBOR manipulation, others may find themselves, better off in some respects and worse off in others. This is especially likely where there have been a wide variety of investments within any particular institution's portfolio. The risk of such a scenario is that the banks are likely to argue that the benefit of the low LIBOR level has to be taken into account, and only net losses (if any remain) fall to be considered. It may actually be that the potential claimant is actually in an overall better position than if LIBOR levels had been where they should have been.

Whether the potential claimant is able to "cherry pick" those loss making contracts, whilst ignoring those from which they have derived a benefit, remains to be seen. Where one contract has seen both 'good' (i.e. profit-making) calculation periods and 'bad' (i.e. loss-making) calculation periods, it is unlikely that a potential claimant will be able to carve out the profit-making periods and pursue a claim solely on the basis of the loss making months. The overall picture for the duration of that particular contract would have to be taken into account. However, where a series of separate contracts are entered into (even if under one overarching ISDA agreement), there may well be scope for ignoring the profitable contracts and concentrating on the loss making ones.

Limitation

As a rule, the limit is 6 years from a breach of contract or 6 years from damage being suffered in an action giving rise to a tort. After this time any action is likely to be statute-barred, meaning that the bank would have a full defence to any claim. However, there are notable exceptions under section 32 (1) of the Limitation Act 1980 where a potential defendant's conduct has been fraudulent, or the potential claimant's right of action has been deliberately concealed by the prospective defendant. In either circumstance, the 6-year period effectively starts again from the time that the would-be claimant discovers the fraud or concealment. As a result, it seems to us that there are good grounds that the time period – certainly in relation to potential claims against Barclays – only started recently, when news of the FSA fine emerged in late June 2012. The third exception under section 32 – where an action is for relief from the consequences of mistake – also warrants consideration, albeit the fraud / concealment grounds previously outlined are likely to provide a more straightforward route. In addition, where an English court is having to apply foreign law (for example, because English courts have jurisdiction pursuant to the underlying contract, albeit the contract itself is subject to foreign law) then The Foreign Limitation Periods Act 1984 will be relevant. As a general rule, it is the foreign law limitation period that will prevail, and this will warrant careful consideration.

Conclusion

This note is necessarily a brief overview of some of the legal issues immediately arising out of the LIBOR manipulation investigations. Investigations into other LIBOR panel banks are continuing and we can expect further evidence to emerge as to how LIBOR may have been distorted during the First and Second Periods referred to above (2005 – 2009). The issues covered in this memorandum and other relevant aspects of this story will be examined in more detail in future editions in this series of notes. In particular, in considering whether to commence any legal action, potential claimants may wish to consider the following:

- Governing law and jurisdiction. A number of class actions have been commenced in the United States already and a care home has also initiated an action in the United Kingdom. Careful consideration will need to be given in each case as to the most amenable jurisdiction for any claim. In particular, claimants should be careful to ensure that any cause of action pleaded against any of the banks in a UK or US court would not be prejudicial to the claimant in the context of any other LIBOR proceedings brought against it in its own jurisdiction.

- Assignment of legal claims. Depending on the exact nature of any legal claim and the relevant governing law and jurisdiction, it may be possible to assign the claim - either together with or separately from - the relevant asset.

- Even where institutions do not pursue actions against rate-manipulating banks, early consideration is required as to what they will do if they face claims in their local jurisdictions from affected clients in order to shift the liability onto the ultimate perpetrators.

- Collective or representative actions. Class actions in the US have already been commenced. In the UK, groups of claimants may be able to co-operate by using the representative action procedure to bring before the Courts questions of law that are common to all of them.

- Litigation funding. The availability of funding for claimants in large scale litigation has increased significantly in recent years. In the UK, the rules on funding and liability for legal costs are in a period of transition. Institutions considering making claims in the UK courts should have regard to the changing landscape.

- The progress of LIBOR litigation in the US and in the UK; and the published results of any further regulatory investigations into LIBOR manipulation.

In the interim, it may be sensible for institutions that held LIBOR-benchmarked assets between 2005 and 2009 to attempt to calculate the aggregate of those holdings over that time. It may also be an interesting exercise to begin an estimation of the sensitivity of any such portfolio to a downward deviation in LIBOR over that period (perhaps by 1 basis point (0.01 per cent) as is suggested in a recent Morgan Stanley report).

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