Libor manipulation probe and litigation update

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The record-breaking £59.5 million fine imposed on Barclays by the Financial Services Authority (FSA) and $360 million penalty imposed by the U.S. Commodity Futures Trading Commission and Department of Justice in connection with the improper submission of London InterBank Offered Rate (Libor) rates has led to intense public scrutiny of Barclays' practices, procedures and management and possible misconduct by other financial institutions. Sedgwick has been watching this issue closely for a few months. In May, Chicago partners Eric Scheiner and Jennifer Broda wrote an article published in the PLUS Journal about the price-fixing cases in the U.S., the development of the investigations, and the impact for insurers before the headlines and Barclays settlement was announced.1

As U.S. **and** U.K. regulators' investigations into the conduct **of** other major banks are ongoing, it seems possible that, depending on their findings, they could also be the subject **of** significant penalties. This may fuel ongoing litigation in the U.S. against financial institutions **and** other parties in relation to Libor manipulation **and** it is possible similar claims may be made in other jurisdictions, such as the U.K.

Below, our financial services team in London **and** the U.S. consider:

- The background to the allegations **of** Libor manipulation.
- Civil proceedings in the U.S. **and** possible future claims.
- Investigations by regulators.
- The implications for insurers.

Background

Libor is the benchmark that establishes the interest rate at which member banks will loan money to each other for a given time period (various periods ranging between one day **and** one year) **and** in a given currency.2 It is established for 10 separate currencies, including the U.S. dollar, the Japanese yen **and** the British pound.3 Similar interbank rates are used in other financial markets, including Tokyo (Tibor) **and** Europe (Euribor).

Besides being used to determine the rate at which member banks loan money to each other, Libor is important for additional reasons. As the primary benchmark for global short-term interest rates, Libor is also important for the pricing **of** fixed income futures, option swaps **and** other derivative products traded on exchanges **and** determining the value **of** products traded on the Over-the-Counter market as well as lending transactions, such as mortgages.

In order to calculate Libor, the banks calculate their own interest rates for the day **and** submit them confidentially to Thomson Reuters, the agency charged with calculating the Libor figure.4 Once Thomson Reuters receives the submissions from each member **bank**, it ranks them in descending order **and** then excludes 25 percent **of** both the lowest **and** highest submissions.5 The remaining submissions are then averaged to reach the daily Libor figure.

While the number **of** member banks may differ, this process is repeated for each **of** the nine other currencies for which Libor is calculated.6 Similar methods are used for setting the Tibor **and** Euribor rates by banks in each **of** those respective geographic areas.

The thrust **of** the allegations made against banks is that they made inappropriate submissions that took into account requests made by their own interest rate derivative traders (**and** traders at other banks) in order to improperly influence the Libor (or Euribor **and** Tibor) rate in order to benefit their trading positions.

Civil Proceedings in the U.S. and Possible Future Claims

In 2011, at least 21 class action lawsuits were filed in various U.S. federal courts against a number **of** Libor member banks.7 The lawsuits were initiated by investors who purchased many millions **of** dollars **of** interest rate swaps tied to Libor (interest rate swaps can be used as a means to hedge against changes in interest rates), by groups **of** customers such as traders who made Libor-related bets, **and** by investors in large companies' debt that was linked to Libor.8

The member banks named in these lawsuits include **Bank of America Corporation**, Barclays **Bank** PLC, Citibank NA, HSBC Holdings plc, JPMorgan Chase & Co., Lloyds Banking Group plc, UBS AG, WestLB AG, Credit Suisse Group AG, Deutsche **Bank** AG, **and** Royal **Bank of** Scotland Group PLC, among others. The U.S. Judicial Panel on Multidistrict Litigation has now consolidated these actions for pretrial purposes in the U.S. District Court for the Southern District **of** New York under the caption *In Re LIBOR-Based Financial Instruments Antitrust Litigation* (MDL No. 2262) (the "MDL"). 9

On April 30, 2012, three amended consolidated class action complaints were filed in the following actions pending in the MDL: (1) ***Mayor and City Council of Baltimore v. Bank of America, et al***. (Case No. 11 Civ. 5450)(the "OTC Action"); (2) *Exchange-Based Plaintiff Action* (Case No. 11 Civ. 2613)(the "Exchange-Based Action"); **and** (3) *Gelboim* ***v.*** *Credit Suisse Group AG,* ***et al***. (Case No. 12 CV 1025) (the "Gelboim

Action"). The OTC, Exchange-Based, **and** Gelboim Actions are brought on behalf **of** different classes **of** plaintiffs,10 but make similar allegations against the banks. The plaintiffs in each **of** these actions essentially allege that the defendants perpetrated a scheme to depress Libor for the U.S. dollar for two primary reasons. First, the plaintiffs assert that because the interest rate a **bank** pays (or expects to pay) on its debt is widely viewed as embodying the market's assessment **of** the risk associated with the **bank**, the defendants understated their borrowing costs to the British Bankers' Association (thereby suppressing Libor) to portray themselves as economically healthier than they actually were. Second, artificially suppressing Libor allowed defendants to pay lower interest rates on Libor-based financial instruments that defendants sold to investors.

Each **of** the consolidated complaints asserts causes **of** action for violation **of** the Sherman Antitrust Act. The Exchange-Based Action also asserts causes **of** action for violations **of** the Commodity Exchange Act. The OTC **and** Exchange-Based Actions further assert claims for restitution, disgorgement, or unjust enrichment. The plaintiffs seek unspecified compensatory damages, treble damages with respect to the antitrust violations, prejudgment interest, establishment **of** a constructive trust with respect to the unjust enrichment claims, **and** attorneys' fees **and** costs.

In addition to the individual **and** institutional investors' claims, the brokerage Charles Schwab has also filed lawsuits against several banks alleging violations **of** antitrust, racketeering **and** securities laws in California federal court (the "Charles Schwab Actions"). Those actions have also been transferred to the MDL.

On June 29, 2012, the **bank** defendants (with the exception **of** Barclays **and** UBS) moved to dismiss the claims asserted in the OTC, Exchange-Based, **and** Gelboim Actions, as well as claims asserted in the Charles Schwab Actions. The defendants argue that the amended complaints do not state a claim under the antitrust laws because they fail to demonstrate how the banks' alleged conduct restricted competition or restrained trade among the defendants or anyone else. According to the banks, the plaintiffs merely accuse defendants **of** making false reports for their own purposes to a trade association regarding the rates at which they believed they could borrow money in London. The banks argue that the amended complaints do not adequately plead any joint action or agreement by competitors to restrain competition in some market, or allege any facts from which such an agreement can be inferred. In addition, defendants assert that the plaintiffs do not allege any conduct that would constitute a restraint **of** trade in violation **of** the Sherman Act. The banks assert that the plaintiffs' allegations regarding false interest rate reporting are not alleged to be **and** are not a competitive act because there are no buyers or sellers, market, profit, or competition **of** any kind associated with the mere reporting **of** rates or setting **of** Libor.

With respect to the Exchange-Based Action, the banks assert that they are time-barred because the plaintiffs' allegations demonstrate they were on inquiry notice **of** potential violations over two years before the initial complaint was filed, as the *Wall Street Journal* published several articles in 2008 regarding the banks' alleged flawed interest rate reporting. The banks further argue that the plaintiffs' claims are impermissibly extraterritorial because they allege manipulation **of** a London-based commodity, **and**

the Commodity Exchange Act does not have any extraterritorial reach. Finally, the banks assert that the plaintiffs fail to state claims for manipulation or unjust enrichment.

The plaintiffs have not yet filed their opposition to the banks' motion, **and** no briefing schedule has been set. The banks indicated in their motion papers that Barclays **and** UBS will be filing separate motions to dismiss, although they will be joining in arguments made by the other **bank** defendants.

Recent news reports indicate that several large institutional investors may follow Charles Schwab's lead **and** opt out **of** the class action lawsuits pending in the MDL. The news articles suggest that large investors want to maintain tighter control over their cases, **and** believe that they can potentially recover substantially larger settlements by proceeding individually.

In the U.K., at least two law firms have indicated they intend to pursue claims against Barclays on behalf **of** impacted parties following its settlement with regulators, although it will be difficult to advance "class actions" in the U.K. in the manner in which they proceed in the U.S.

It is also conceivable civil claims could be commenced against other parties, such as brokers, who may have been involved in the alleged misconduct – as set out below, a number **of** these entities are currently being investigated by regulators.

Many banks have dismissed or suspended employees who are implicated in alleged Libor manipulation. There is a risk such dismissals (**of** well remunerated individuals) could give rise to an increase in employment claims **and** incentivize disgruntled employees to assist prosecutors **and** plaintiffs. For example, the Royal **Bank of** Scotland Plc has reportedly dismissed at least four employees in connection with its internal probe into the manipulation **of** these rates.11 In response, one **of** those terminated traders, Tan Chi Min, has filed a wrongful dismissal action in the Singapore High Court.12 In that wrongful dismissal action, Min alleges that it was "common practice" for Royal **Bank of** Scotland senior employees to make Libor-related requests to the Libor rate setters **and** that such conduct was known to senior management.13

According to other reports, employees have been dismissed, placed on leave or suspended at JPMorgan Chase, Deutsche **Bank and** Citigroup.14 In addition, although no conclusions **of** wrongdoing have been made, at least two senior UBS traders were suspended in connection with the probe15.

Investigations by Regulators

Various governmental agencies have announced criminal investigations into whether member banks committed Libor manipulation, **and** such investigations have spread over three continents. Investigations are currently being conducted by the U.S. Securities **and** Exchange Commission, U.S. Commodity Futures Trading Commission, U.S. Department **of** Justice, Japan's Financial Supervisory Agency, the U.K. FSA,

Canada's Competition Bureau, the European Commission, **and** the Swiss Competition Commission, among others.16

Some **of** the banks that have disclosed that they have been approached by regulators investigating Libor include Barclays Plc, Royal **Bank of** Scotland Group Plc, HSBC Holdings Plc., Citigroup, Inc., UBS AG, Credit Suisse, Deutsch **Bank**, JPMorgan Chase & Co., Tokyo-Mitsubishi UFJ, Mizuho Financial Group Inc., Rabobank Groep N.**V.**, Societe Generale, **and** Sumitomo Misui Banking **Corporation**.17

As noted above, Barclays were recently fined £59.5 million by the FSA for misconduct relating to Libor **and** Euribor submissions **and** has paid $360 million in penalties to the U.S. Commodity Futures Trading Commission **and** Department **of** Justice.

Japan's FSA has also imposed sanctions with regard to wrongdoing. In December 2011, Japan's FSA sanctioned Citigroup by demanding the temporary suspension **of** trading derivative products tied to Tibor **and** Libor after two Citigroup traders were accused **of** trying to improperly influence Tibor by asking other banks for an advantageous rate in violation **of** Japan's Financial Instruments **and** Exchange Act.18 UBS reportedly received a smaller sanction as well for allegedly similar misconduct.19 The reports indicate that there was no evidence that Tibor was actually manipulated, but Japan's FSA took the position that both banks lacked appropriate internal controls to prevent such manipulation.20 In addition to the sanctions, Citigroup announced a $50 million write-off unwinding the two traders' positions.21

We will have to wait **and** see whether other banks will be found to have been involved in similar misconduct **and** what action regulators in different jurisdictions may take against them.

The investigations do not stop with just the banks. There have been allegation that brokers communicated with traders at various banks in an attempt to influence the various types **of** rates. Some **of** the brokerages reportedly being investigated include ICAP Plc, Tullett Prebon **and** RP Martin Holdings Ltd.22

Implications for Insurers

Claims or investigations may potentially implicate directors **and** officers **and** E&O insurances.

To date, it does not appear that any individual directors **and** officers **of** banks have been implicated in the MDL litigation, but consolidated amended complaints are still being drafted **and** there is a potential for litigation involving directors **and** officers with regard to the alleged misconduct.

The costs associated with the defense **of** these types **of** actions, the civil litigation exposure **and** the potential for civil **and** criminal penalties could be very significant given the widespread impact these interbank rates have on various financial instruments. In this regard, if these costs **and** exposures are borne by the financial

institutions themselves, derivative claims (either in the U.K. or U.S.) against directors **and** officers relating to improper oversight are a possibility. Moreover, if there are any alleged public misrepresentations or material omissions made by the financial institutions in their financial statements or otherwise, class action securities litigation is also a possibility.

Investigations by regulators may also give rise to claims for reimbursement **of** costs incurred by or on behalf **of** directors **and** officers for the legal costs that are incurred in advising them.

A number **of** banks may have blended insurance programs with several types **of** coverage. As such, the banks may attempt to tender actions related to this alleged misconduct to their errors **and** omissions coverage depending on the circumstances **of** the case. Additionally, should regulators determine that criminal activity was also involved, fiduciary bond policies could be impacted as well. Finally, in light **of** the various terminations **of** likely well-compensated traders, there could be additional significant employment practices liability claims that are made.

As a result **of** the potential involvement **of** brokers **and** hedge funds, claims could also eventually be made against those types **of** entities, potentially implicating their insurers. Depending on the scope **of** the various investigations **and** the level **of** involvement with other financial institutions, smaller banks could also eventually be implicated.

Conclusion

News about the various ongoing international investigations is coming out on almost a daily basis but based on the information that has come to light it appears at least some attempts to manipulate these various interbank rates may have occurred.

In light **of** the significant volume **of** financial products tied to these rates, the exposure to financial institutions **and** other entities presented by these investigations **and** litigation has the potential to be as large as some **of** the biggest securities class actions settlements that have arisen out **of** the subprime scandal. Based on what has transpired to date, it is foreseeable that more criminal investigations will be announced **and** more charges brought.