National Insolvency Review

General Editor: Justin R. Fogarty, B.A., LL.B., LL.M

VOLUME 29, NUMBER 1 Cited as (2012), Nat. Insol. Review FEBRUARY 2012

• THE 2008 CREDIT FREEZE AND ITS REPERCUSSIONS *BARCLAY v. DEVONSHIRE*, MISREPRESENTATION AND BAD FAITH •

Ray Schachter, Alexander Holburn Beaudin & Lang LLP

The meltdown of the world economy from early 2007 through the end of 2011 and which is still ongoing is unparalleled. Globalization, along with electronic communication and the computerization of banking and business, has added a new dimension to the current economic troubles. The dramatic demise of the economy and plummeting value of very significant and sophisticated investments have given rise to complex and interesting litigation.

1. Introduction

This article focuses on *Barclays v. Devonshire*,[1] a case heard in the Ontario Superior Court arising as a consequence of the economic crisis in 2008, when the Canadian market for Asset Backed Commercial Paper ("ABCP") collapsed.

Barclays is a U.K.-based bank, self-described on its website as:

> *With over 300 years of history and expertise in banking, Barclays operates in over 50 countries and employs over 145,000 people. Barclays moves, lends, invests, and protects money for customers and clients worldwide.*[2]

Devonshire was a special-purpose conduit created for the transactions under scrutiny in the litigation described below.

2. Risk and Reward — 2004-2007

The background of the economic problems western economies now face includes the disassociation of risk from reward. Traditional investment models demand that a risk analysis be performed to determine if the reward justifies the risk. For typical investments such as government bonds, corporate bonds, stocks, and real estate investments, risk analysis methods are well known.

• In This Issue •

NATIONAL INSOLVENCY REVIEW

The **National Insolvency Review** is published bi-monthly by LexisNexis Canada Inc., 123 Commerce Valley Drive East, Suite 700, Markham, Ontario L3T 7W8

ISBN: 0-409-91078-3 ISSN: 0822-2584
ISBN: 0-433-44393-6 (Print & PDF)
ISBN: 0-433-44694-3 (PDF)

Subscription rates: $410/year (Print or PDF)
$500/year (Print & PDF)

Please address all editorial inquiries to:

Boris Roginsky, Journals Editor
LexisNexis Canada Inc.
Tel. (905) 479-2665; Toll-Free Tel. 1-800-668-6481
Fax (905) 479-2826; Toll-Free Fax 1-800-461-3275
E-mail: nir@lexisnexis.ca.

In bubble economies (*e.g.*, the United States real estate market in 2007), investors, buyers, and lenders, for a variety of reasons, underestimated risk. When there is too much liquidity in the system and excessive competition for investments, investors are prone to reducing their risk criteria. When this happens, it becomes easier to sell investments that are difficult to evaluate or have "good credit ratings", even though the actual risks may have increased.

Syndicators, including Wall Street investment banks, took advantage of this situation. They created and issued products that had limited market liquidity, good credit ratings, and were extremely difficult to value, both in terms of intrinsic value and risk. The credit ratings were delivered by rating agencies who were paid by the issuers.

3. Economic Crisis – 2007-2011

The markets unravelled in late 2006, although the underlying causes emerged decades earlier. Blame has been attributed to many factors, including Wall Street financial institutions,[3] large mortgage lenders, lack of or inadequate government regulation, and economic models based on free markets and the assumption that people act rationally when making economic decisions, which is now in some doubt.[4] As previously mentioned, globalization, along with the ease with which money was moved around the world and investments packaged to obscure their true underlying value, were also contributing factors.[5]

(a) Deregulation and the Savings and Loan Crisis — Early 1980s

The trend towards deregulation in the banking industry in the U.S. in the early 1980s, commonly known as Reaganomics,[6] led to the

Savings and Loan Crisis[7] in the late 1980s. Previously, U.S. Savings and Loan associations ("S&L") were regulated by U.S. federal law and restricted to offering homeowner loans at a low fixed percentage rate. The S&Ls were generally locally run and very conservative, offering a needed financial service to homeowners not available elsewhere. Deposits in S&Ls were federally guaranteed to a specified limit, giving depositors a secure investment with a modest return.

S&Ls were deregulated under the Reagan Administration. This presented an opportunity for many unscrupulous businessmen to gain control over S&Ls and use depositors' money to loan on virtually any security with little regard to risk.

It is estimated that 747 S&Ls failed shortly following deregulation; the U.S. federal government had to intervene to rescue depositors at a cost of over $87 billion. The result created a general slowdown of the economy in the U.S. along with budget deficits for many years, into the 1990s.

The term "moral hazard" is sometimes used to describe the hazard of permitting a financial institution to lend while the risks are borne by a third party. In the case of the S&Ls, the third party was the government. S&L depositors were federally insured (at least to a certain limit), but the federal government did not oversee the lending practices of the S&Ls.[8] The moral hazard concept can arise in the management of banks that are "too big to fail".

Some of the more corrupt S&L executives were prosecuted and jailed.

(b) Junk Bonds — 1980s

The subject of junk bonds is discussed in the section entitled "The Sub-Prime Crisis".

(c) Long-Term Capital Management — Late 1990s

In the late 1990s, several former Salomon bond traders and two future Nobel Prize winners in economics created and ran a hedge fund called the Long-Term Asset Management Fund ("LTCM") and made a huge bet on the Russian ruble. The Russian economy crashed in August 1998; Russia defaulted on its debt and the ruble was devalued.[9]

Per Wikipedia:

> *[LTCM] did business with nearly everyone important on Wall Street. As LTCM teetered, Wall Street feared that LTCM's failure could cause a chain reaction in numerous markets, causing catastrophic losses throughout the financial system. After LTCM failed to raise more money on its own, it became clear it was running out of options. On September 23, 1998, Goldman Sachs, AIG, and Berkshire Hathaway offered then to buy out the fund's partners for $250 million, to inject $3.75 billion and to operate LTCM within Goldman's own trading division. The offer was stunningly low to LTCM's partners because at the start of the year their firm had been worth $4.7 billion. Buffett gave Meriwether [head of LTCM] less than one hour to accept the deal; the time period lapsed before a deal could be worked out.*
>
> *Seeing no options left the Federal Reserve Bank of New York organized a bailout of $3.625 billion by the major creditors to avoid a wider collapse in the financial markets.*[10]

LTCM was considered "too big to fail" and therefore had to be bailed out by the government. While the amount of money involved seems modest by today's standards, this action made the bailout concept legitimized.

(d) The Dot-com Bubble — 2000-2001

The economic situation, at least superficially, seemed vibrant during the Clinton years, spanning 1992 to 2000. The economy was very

strong and there was a transformation in industry due to the emergence of the Internet, resulting in the Dot-com Bubble.[11]

During the Dot-com Bubble there was widespread belief that normal commerce would be transformed into e-commerce. The shares of companies without business plans, histories, or operations, were offered to the public in IPOs at non-supportable prices. There was no relationship between the price of new offerings and the performance of the companies. Promoters of the IPOs made a lot of money, and the retail investor ultimately paid the price.

The Bubble burst in 2001, resulting in corporate failures and catastrophic losses in the stock market. Many of the stocks crashed from their IPO prices and became virtually worthless. There was limited effort by the Bush Administration to take action against the most egregious participants, such as the principals of Enron. The worldwide accounting firm of Arthur Anderson went into bankruptcy.[12]

(e) The Subprime Crisis — 2005-2012

President Clinton's closest financial advisors were Larry Summers and Robert Rubin. Alan Greenspan was the head of the Federal Reserve. They were all advocates of deregulation. Although they departed government when the Bush Administration was elected, the newly-appointed advisors held the same, if not more conservative, views.

The subprime mortgage market that gave rise to Collateralized Debt Obligations ("CDO") and Credit Default Swaps ("CDS") began to emerge in 2004.[13] The world was awash with capital. Liquidity was produced by lax lending policies, the speculative housing bubble, and the extension of credit by China to the U.S., among other things.

Wall Street financial institutions have a long history of creating various syndicated loans and other securities instruments for purchase by banks, institutions, pension plans, and municipalities, among other bodies. Syndicators were aware that money was available from these sources and that they could create and control an incredibly lucrative market. By 2005, this market became known as the subprime and CDO market. The ability to control the market assured the syndicators, as intermediaries, substantial profit with little risk. The traditional role of the private banks or near banks expanded from offering mezzanine financing and investment advice to wealthy individuals and institutions to include these sophisticated offerings to their "clients".

Michael Lewis writes about the origins of the subprime disaster in his book *The Big Short*.[14] At p. 61 he observes that the stock market "was not only transparent but heavily policed. It had been legislated and regulated to at least seem fair." But:

> *The bond market, because it consisted mainly of big institutional investors, experienced no similarly populist political pressure. Even as it came to dwarf the stock market, the bond market eluded serious regulation. In the bond market it was still possible to make huge sums of money from the fear, and the ignorance of customers.*[15]

Manipulation of the bond market is nothing new. In the 1980s, Michael Milken made almost a billion dollars while controlling "junk bonds". The junk bonds that Milken traded were mainly bonds issued by companies that were at a higher risk of default. Milken made the market; he brokered the deals rather than holding the bonds, or, if he held bonds, he was able to sell them before taking losses.[16]

> *Milken was indicted on 98 counts of racketeering and securities fraud in 1989 as the result of an insider trading investigation. After a plea bargain, he pled guilty to six securities and reporting violations but was never convicted of racketeering or insider trading. Milken was sentenced to ten years in prison and permanently barred from the securities industry by the SEC. After the presiding judge reduced his sentence for cooperating with testimony against his former colleagues and good behavior, he was released after less than two years.*
>
> *Milken's compensation, while head of the high-yield bond department at Drexel Burnham Lambert in the late 1980s, exceeded $1 billion in a four-year period, a new record for US income at that time. Drexel went bankrupt in 1990. With an estimated net worth of around $2 billion as of 2010, he is ranked by Forbes magazine as the 488th richest person in the world. Much of that wealth comes from his success as a bond trader; he only had four losing months in 17 years of trading.*[17]

It seems that little was done to regulate the bond industry following the junk bond scandals.

Subprime mortgages, syndicated asset-backed bonds, and other instruments sold to investors during the period of 2004-2008 have much in common with junk bonds. The role played by Milken was filled by "conduits" acting as intermediaries and packagers of subprime mortgages and other securities. Originators such as banks and mortgage companies sourced mortgages from home owners, many of whom had insufficient resources to repay, and packaged and sold them to the conduit. The conduit then created a "bond" (or "CDO") comprised of various tranches of securities, which it sold to institutional or retail investors. The originator, who intended to sell the mortgages, had little concern about whether the mortgagees would default. They made their profits on commissions and the spread when they sold the portfolio at profit. The conduit was often a single-purpose entity without substantial resources. The ultimate risk was taken by the buyers of the "bonds".[18]

In order to provide investors with some comfort, the conduits, as issuers, employed a variety of techniques to get the rating agencies to rate the "bonds" in a higher category. The conduits paid the rating agencies.[19]

In essence, the originators had no risk once they sold their portfolios, the credit agencies were shielded from legal action and were paid by the conduits, and the conduits had no assets or laid off the risk on others. No one was accountable for evaluation and risk assessment.[20]

The other comfort frequently offered to investors by conduits was a hedge or credit default swap ("CDS") as backup insurance in the event of default.[21] This assumed the insurer would have the resources to pay it off if the bet went bad.[22] The largest insurance company in the U.S., AIG, was a major insurer of CDOs, and its ultimate fate is well known. Expecting no significant defaults, AIG offered CDS at bargain rates without sufficient concern about the magnitude of risk.

The real property market had been rising unsustainably for years fuelled by the easy credit offered by the originators. It was a ticking time bomb.[23] [24]

4. Barclay v. Devonshire and ACBP

(a) The Emergence of ABCP Freeze

ABCP were bonds created and sold by intermediaries or conduits backed by the IOUs (sometimes secured) of various Canadian companies needing short-term funds for operating capital. This market was and still is totally unregulated. Because the intermediaries were often major Canadian banks or bank subsidiaries, retail and institutional buyers of ABCPs were confident

that the banks would step in to make good on any problem in this market.[25]

One would expect the banks to carefully assess the risk of default by the companies in repayment if they were going to stand behind the conduits. A default or even a temporary halt by buyers of ABCPs to roll over their investments would deprive the conduit of funds to repay the ABCP holders who wanted to cash out.

The commitment fees on ABCP were lucrative; spreads between the rates paid by the companies for short-term borrowing and by banks to depositors were significant. Private conduits were attracted to the arena. Since single-purpose private conduits had no real covenant, the purchasers of ABCP relied on the underlying collateral, whatever it was. Devonshire was a private conduit.

(b) The Background and Facts Leading up to the Montreal Accord

The CDS business is complex. It worked as follows for Barclay and Devonshire:

(i) Devonshire was set up by Mr. Lafleur-Ayotte and Mr. Pelchat, who were previously with National Bank, to act as a conduit that would acquire income-producing assets financed through issuance of ABCP. It was a single-purpose entity that could only buy those assets from Barclays.

(ii) Devonshire would fund the purchase by issuance of ABCP to investors.

(iii) The assets that Devonshire purchased from Barclays were two CDSs called "synthetic leveraged super senior credit default swaps". Barclays did not own the securities insured through the swaps (thus the term "synthetic") but was making a bet that the securities would go down in value, in which case Devonshire would have to pay Barclays to make up the difference in value. Barclays was in the business itself of acting as a swap dealer, an intermediary between sellers and buyers of credit protection, making a spread on the sale price of selling the insurance and the cost of buying matching insurance.

(iv) Barclays paid Devonshire monthly for the "insurance". Payments under the CDS were used by Devonshire to pay note holders that had purchased ABCP from Devonshire. The note holders were taking a major risk if Devonshire had to pay out on the CDSs. The Agreements governing the relationship between Barclay and Devonshire were extremely complex, including the ISDA Master Agreement (see below).

(v) The actual pool of securities that Devonshire insured consisted of 130 corporate bonds issued by various corporations in the first swap and 100 in the second swap, all negotiated between Barclays and Devonshire. In the negotiation, presumably Devonshire wanted to minimize the risk of having to pay Barclays by increasing the credit worthiness of the corporate debtors and the security under the bonds. Barclays would want to minimize the premium it had to pay Devonshire.

(vi) To secure a possible call on Devonshire in the event of default, Devonshire had to escrow $600 million as collateral. If there were no defaults, Devonshire would get

back the $600 million in 2016 and presumably use it to repay the investors. Devonshire's actual exposure was $6 billion and it had no resources other than the escrowed funds to come up with the difference in the event of a default under the insured bonds (the swap was non-recourse, in any event). The leveraging allowed Devonshire to be paid premiums on $6 billion of exposure for collateral worth only one tenth of that amount. Neither Barclays nor Devonshire expected that there would be losses due to default.

(vii) Devonshire raised money from investors by issuing a variety of notes. Investors would typically roll over the notes, but if they did not, Devonshire would have to go back to the market for funds to replace the maturing notes. If Devonshire encountered a market disruption event, creating a liquidity crisis, Barclays agreed to supply Devonshire with up to $205 million in liquidity payments. Devonshire paid Barclays a monthly fee for this "protection".

(viii) On August 13, 2007, the independent ABCP market froze in Canada. This resulted in Devonshire making a liquidity call on Barclays.

(ix) The entire Canadian ABCP market froze on August 14, 2007. From August 13 to 16, 2007, the major players in this market met in Montreal with plans to agree on a moratorium on collateral and liquidity calls. The agreements governing the ABCPs, the conduits, and the borrowing corporations were extremely complex and there was a realization that the economy would be seriously adversely impacted by defaults. On August 17, Montreal Accord was announced, being essentially a forbearance on taking legal action and a framework for restructuring. Barclays did not sign the framework agreement because it did not want to make the necessary concessions that it would entail.[26]

The Facts following the Montreal Accord

(i) When the market froze, Devonshire was unable to roll its Class A notes for new notes to pay the note holders, whose notes had become due. Devonshire sent market disruption notices to Barclays on August 13, 14, and 15 requesting liquidity payments from Barclays. Barclays took the position that no market disruption event as defined in the relevant agreement had occurred and refused to provide any liquidity payments to Devonshire. On August 14, 2007, Devonshire delivered a default notice to Barclays, the effect of which was to give Barclays three days to cure the default.

(ii) Because of the Montreal Accord, and in order to allow negotiations to take place with a view to restructuring Devonshire, Devonshire delivered a suspension notice to Barclays on August 16, 2007 in which it suspended without prejudice the effect of the default notice and agreed not to take any further steps to enforce its rights under that notice until the end of the Standstill Period. Barclays wanted Devonshire to simply rescind the default notice, but Devonshire refused. The suspension notice was extended for fixed periods of time until February 22, 2008, then daily until

March 14, 2008, then for a fixed period until April 16, 2008, and thereafter on a daily basis until January 12, 2009.

(iii) The last daily extension between Barclays and Devonshire was made on Friday, January 9, 2009, effective through the close of business on Monday, January 12, 2009.

(iv) Shortly after 9:00 AM on January 13, 2009, Barclays delivered a notice to Devonshire purporting to terminate the ISDA Master Agreement based on an alleged insolvency of Devonshire. Just moments before that, Barclays had given notice that it would pay a liquidity payment to Devonshire under protest, and these funds, some $71 million, were sent by Barclays just before 9:00 AM and received in Devonshire's bank account around 11:00 AM that morning. Barclays also issued and served its statement of claim that morning, commencing this action.

(v) Devonshire did not accept that Barclays had grounds to terminate the ISDA Master Agreement. On the same day, at 2:22 PM, Devonshire delivered a notice to Barclays purporting to terminate the ISDA Master Agreement for failure of Barclays to pay the liquidity calls made by Devonshire on August 13, 14, and 15, 2007.[27]

(c) The Decision of Mr. Justice Newbould

Justice Newbould found that Devonshire was entitled to $532,668,082, which together with the approximately $71 million already paid, would be full recovery of the $600 million it had deposited as security for the swaps. [28, 29]

(d) The Evolution of the Devonshire Strategy

Devonshire was surprised to receive the default notice from Barclays, which followed within minutes of the alleged payment of the liquidation payment and email from Barclays indicating the payment was made without prejudice. In fact, at the time the Trustees of Devonshire were not able to use the liquidation payment to pay their note holders because there were disputes as to priority amongst the note holders. This was well known to Barclays, who saw little risk that the Trustees of Devonshire would pay out the liquidity payment and possibly face personal liability. In any event, Barclays was prepared to and did commence action immediately for an injunction and return of the money.

The only route available to Devonshire was to allege non-payment or deficient payment, which it did in its 2:20 PM notice to Barclays.

Counsel for Devonshire consisted of four senior lawyers led by Tom Curry.[30] They were assisted by a variety of support staff who reviewed the voluminous electronic record, which demonstrated Barclays' scheme to remedy its default by making the liquidation payment, albeit under a form of protest, and then serve its own default notice on Devonshire. They were also assisted by structured finance advisors.

At the outset, but with no knowledge of the bad faith and misrepresentations of Barclays which emerged later at discovery, Counsel for Devonshire concluded that they would have to quash the suspension notices of January 8 and 9, thus putting Barclays in default by close of business January 12 (see further details below).

It is clear that counsel for Devonshire set out to attack the credibility of Barclays' witnesses from the outset and that they were successful in doing so.[31] This outcome and Barclays' transparent scheme to outflank Devonshire set the stage for Devonshire's victory.

Of some undoubted significance, morally if not legally, is that Devonshire's main note holder was the Caisse Populaire, which is the pension fund for Quebec. A loss for Barclays, given its assets and operations, would be modest and borne by its shareholders if it had any impact at all. The Caisse apparently innocently invested in the notes in good faith, achieving a modest return over other instruments in the market. Following expedited discoveries which lasted one-and-a-half weeks, there was a 50-day trial, by the end of which Newbould J. was not impressed by Barclays' witnesses, nor its course of conduct. These issues clearly had an impact on the result.[32]

Barclays also brought an application for an injunction for return of the money. In this rather ingenious application, Barclays argued that Devonshire was "interfering with its contractual rights" by objecting to the payment to Barclays of the $600 million in escrow. This application was heard on February 19, 2009 and dismissed by Justice Campbell.[33]

(e) The Evidence and the Law

The following issues were argued by Devonshire and Barclays and appear in the Judgement in the order set out below.

(i) Did Barclays waive its right to remedy its default?

Barclays was allegedly in default of payment of the liquidity call. Barclays attempted to cure the default by paying the $71 million call but did so concurrently with notice that it was not obligated to pay and that it reserved all its rights under the ISDA Master Agreement, including the right to demand return of the money. Devonshire argued that because of the "conditions" on the payment, Barclays had waived its right to cure. If Devonshire was right, Barclays would have been in permanent default and thus could not have terminated the ISDA Master Agreement as it purported to do on January 13. After an exhaustive review of the law on waiver, Newbould J. concluded at para. 65 that Barclays had not communicated a clear intention to waive its right to cure.

(ii) The Effect of the Suspension Notice

There was argument regarding the suspension notice, particularly the wording stating it was "without prejudice". As common sense dictated, Newbould J. determined at para. 81 that by construing the language of the suspension notice and considering its factual matrix, the time during which Barclays had to pay the existing liquidity calls to remedy its failure was suspended during the period of the suspension notices.[34] However, Newbould J. added that Barclays had used one of the three days it had to cure because the suspension notice did not become effective until a day following the default.[35]

(iii) The Misrepresentation Claim

The misrepresentation claim and bad faith claims are at the heart of this decision. Barclays had three days to cure its failure to pay the liquidity payment under the ISDA. One day had elapsed, and so Barclays had two days remain-

ing. If the renewals of the suspension notices on January 8 and 9 were ineffective, those two days would have expired as of close of business on January 12, entitling Devonshire to terminate the swaps on January 13.

Devonshire argued that due to misrepresentation, the January 8 and 9 suspension notices given by Barclays were ineffective. Justice Newbould analyzes the evidence very thoroughly on the claim of misrepresentation.[36] On the morning of January 13, Devonshire, ignorant of the misrepresentations, would have assumed that it would have to wait until before January 15 to terminate (assuming Barclays did not cure by that time). Justice Newbould analyzes the facts at para. 112-153 and concludes at para. 154:

> *Given that Barclays had sent out a term sheet to the Caisse on January 8, 2009 as an ultimatum, which the Barclays people involved in the transaction did not think the Caisse would accept, and given that Barclays intended to terminate the trades once the Caisse did not accept the ultimatum, all of this before the extensions that of January 8 and 9, 2008 were sent, the extensions were misleading, both in the language used and in what was not said. It was misleading to say that there were issues being worked out. The negotiations were over from Barclays' point of view. Moreover, having made the statements that it did, it was misleading for Barclays not to disclose the ultimatum that it had made and its intention to terminate the trades if the ultimatum, which it did not think would be accepted, was declined. Thus the daily extensions of January 8 and 9, 2009 contained misrepresentations of facts.*

and later at para. 181 referring to extensive email evidence:

> *While it is not strictly necessary for the purposes of the misrepresentation claim to determine whether the misrepresentations amounted to a fraudulent misrepresentation, in my view they did. Mr. Neville, who sent the extension e-mail of January 8, 2009, and the Barclays sales team knew that there were not a number of issues being worked out between Barclays and the Caisse and knew that the negotiations were at an end. They also knew of relevant facts such as the ultimatum put to the Caisse and the intention to terminate when the Caisse did not accept [[2011] O.J. No. 3988, Page: 55] the ultimatum, which they expected would occur. The extension e-mail of January 9, 2009 was sent by Ms. Sheila Chapman, an in-house lawyer at Barclays in the New York. What she knew is not in evidence as it is a privileged matter. However, the e-mail was copied to Mr. Neville and others in the Barclays sales team who again knew of the misrepresentations. I view these e-mails as being part of the litigation strategy that shortly thereafter unfolded. Barclays did not want to disclose to Devonshire what was going on with the Caisse and did not want to run the risk that Devonshire might terminate the swaps before it did. The e-mails, to the knowledge of the Barclays sales team, were false.*
> [Emphasis added]

The comments on the credibility of the witnesses earlier in the decision and throughout the misrepresentation portions of the decision are particularly telling. It is clear that Justice Newbould felt Barclays witnesses were disingenuous at best and were not found fraudulent simply because there was no need to do so.

(iv) Can Barclays rely on the insolvency of Devonshire to terminate the swaps?

Barclays argued that because Devonshire was insolvent (and it was as the Trustee was defending the action), Devonshire, being in default of the ISDA, was prohibited by the terms of the contract to terminate the swaps.

The argument failed. Per Newbould J. At paras. 252-254:

> *Devonshire contends that if, as Barclays suggests, it was possible for Barclays to refuse to perform its covenants and then capitalize on this refusal by terminating the swaps, the rationale behind the entire program would be undermined. Devonshire's arrangements could scarcely have been rated as they were if it were made plain to DBRS that Barclays could terminate the swaps in reliance on the consequences of its own failure to respond to a market disruption notice.*

(v) Could Barclays cure its failure to make the liquidity payments?

The common sense answer at para. 262 is yes.

(vi) Did Barclays make the liquidity payments on time to enable it to terminate the swaps?

Barclays had to cure its payment default before terminating the swaps because the ISDA prohibited termination by a party in default. The timing of the payment was critical and there is a very esoteric discussion about when wired funds are actually received.

Per Newbould J.:

> *[294] In my view, Barclays acted unreasonably in moving with the haste that they did. They should have waited for a reasonable time to ensure at least that the funds had reached Devonshire's bank account. But whether or not Barclays acted reasonably, I find that Barclays failed to make payment of the outstanding liquidity amount before purporting to terminate the swap contracts.*

(vii) Did Barclays act in breach of a duty of good faith?

Justice Newbould finds that Barclays did breach its duty of good faith and the cases relating to that duty are cited and referred to in his decision. Extracts of his judgement express this eloquently. He first describes the "plan" at para. 307:

> *Barclays took a number of steps leading to the termination of the swap contracts. The steps were taken pursuant to an obvious plan. It would be artificial to look at each step as taken independently of the other steps. They were all part of a concerted effort. The plan began no later than January 8, 2009 when, as Mr. Lovisolo said, they intended to 'blow up the box', meaning to terminate the trades, for the economic reasons that he expressed to Mr. Truell that day.*

Justice Newbould finds that prior to the end of 2008, Barclays and the Caisse were asserting commercial positions in very difficult economic times that they were entitled to assert. But by the ultimatum Barclays put to the Caisse on January 8, 2009, Barclays reverted to a position taken eight months earlier in much different economic circumstances, and knew the Caisse would not accept. Barclays had no intention other than to terminate the trades when that occurred: "The ultimatum did not constitute good faith bargaining, but rather the first step in Barclays' termination and litigation strategy."[37]

> *[309] The timing of the standstill agreements was not coincidental but rather designed to permit payment of the outstanding liquidity amounts on January 13, 2009 just minutes before the early termination notices to be delivered to Devonshire that morning. These standstill extension agreements induced by misrepresentation were the antithesis of good faith actions. Devonshire was entitled to the true facts from Barclays, which it did not receive.*

As to the consequences of the breach, Newbould J. held at para. 316 that due to its breach of good faith obligations to Devonshire, Barclays could not rely upon the extensions of the standstill agreements or the conditional payment made to Devonshire on January 13, 2009 and, of course, it follows that Barclays could not rely on its notice of early termination on January 13, 2009.

(viii) Did Barclays have the right to terminate the ISDA Master Agreement?

Here Newbould J. comes to the most interesting finding which, in essence, gets Devonshire its desired result. He finds Barclays actually repudiated the ISDA. His conclusions are worth reading verbatim.

> *[318] The delivery of the notice of early termination and the other steps taken, including the litigation that immediately followed, constituted a repudiation by Barclays of the ISDA Master Agreement and related agreements. Repudiation can be by words or conduct evincing an intention not to be bound by the contract. Such an intention may be evinced by a refusal to perform, even though the party refusing mistakenly thinks that he is exercising a contractual right. See Waddams, The Law of Contracts, supra, at para. 620.*[38]

Building on the repudiation, Newbould J. finds at para. 324 that the notice given by Devonshire which alleged Barclays' failure to pay the liquidity amounts was in effect an acceptance of

the repudiation by Barclays, *irrespective of the exact wording of the notice*. Because the bankruptcy of Devonshire had been waived by Barclays, Devonshire was non-defaulting at the time and thus in a position to serve its notice.

5. Summary of Findings

Justice Newbould has made it difficult for Barclays to successfully appeal for the following reasons:

(i) The notice of default that Barclays served on Devonshire at 9:04 AM was not only ineffective because served when Barclays was itself in default of paying the liquidity amount, but was in effect a repudiation of the ISDA Agreement;

(ii) Even though Barclays' payment would have otherwise remedied Barclays' default, it was too late;

(iii) Even if Barclays was not in default when it served its default notice, the default notice specified financial distress as Devonshire's default. However, Barclays was found to have elected not to terminate the swap contracts on the basis of the insolvency of Devonshire and could not reverse its position on January 13.

(iv) Devonshire's inability to pay its notes was at least partly due to Barclays' refusal to pay the liquidity payment and Barclays could not rely on Devonshire's insolvency caused by Barclays' wrongdoing.[39]

(v) Because of Barclays' breach of duty of good faith (with specific reference at para. 316 to the "conditional payment"), it could not rely on its notice of early termination.[40]

After a lengthy discussion of damages, Newbould J. awards Devonshire $532,668,082. This appears to be net of the $71 million paid by Barclays to Devonshire under the liquidity call.

The case is currently under appeal in the Ontario Court of Appeal.

6. Summary and Conclusions

The problems associated with moral hazards and a lack of regulation of the derivatives markets are readily seen from the historical facts. It is likely that if the G20 (including the U.S.) decide to regulate this market, investment banks will create other types of investments that will technically avoid the regulations. There does not seem to be an appetite for regulation at this time.

The case clearly sets a bar for misrepresentation, the consequences flowing from misrepresentation, and bad faith as part of business dealings.

[*Editor's note*: Ray Schachter has been practising law since 1972 and is Associate Counsel with Alexander Holburn Beaudin & Lang LLP, a long established regional law firm in Vancouver, Canada. He has a wide range of experience in complex corporate and commercial matters in Western Canada. For the past several years, Mr. Schacter has again taken up legal writing, bringing together his interest in mergers, acquisitions and financing with his concerns about legal ethics. He has done the occasional blogging and keeps current on science which is his first passion.]

---

1 *Barclays Bank PLC v. Devonshire Trust (Trustee of),* [2011] O.J. No. 3988, 2011 ONSC 5008.

2 Barclays, "About Us," online: Barclays <http://group.barclays.com/About-us>.

3 The history of Goldman Sacks and its operations during the economic crisis makes for interesting reading. At the time that Goldman Sacks was betting against

subprime mortgages on its own account, it was selling CDOs comprised of those same mortgages to its clients without disclosure. Describing the settlement, the Huffington Post online observes that following the $550 million settlement with the SEC, Goldman stock soars. See *The Huffington Post*, "Goldman Sachs SEC SETTLEMENT Reached -- And Stock SOARS" (15 July 2010), online: *The Huffington Post* <http://www.huffingtonpost.com/2010/07/15/goldman-sachs-sec-settlem_n_648045.html>.

[4] *The Globe and Mail*, "Economics has met the enemy, and it is economics" (15 October 2011), online: *The Globe and Mail* <http://www.theglobeandmail.com/news/politics/economics-has-met-the-enemy-and-it-is-economics/article2202027/>.

[5] Robert Reich, who is Professor of Public Policy at University of California, Berkley and served in three national administrations, has written about the concentration of income and wealth at the top and the effect this has on the economy in his recent book, *Aftershock: The Next Economy and America's Future*. See Robert B. Reich, Aftershock: The Next Economy and America's Future, (New York: Alfred A Knopf, 2010).

[6] Reaganomics, a portmanteau of Reagan and economics attributed to Paul Harvey, refers to the economic policies promoted by U.S. President Ronald Reagan during the 1980s, also known as supply-side economics and called trickle-down economics, particularly by critics. The four pillars of Reagan's economic policy were to: 1.Reduce Growth of Government spending; 2.Reduce Income Tax and Capital Gains Tax; 3.Reduce Government regulation; and 4.Control the money supply to reduce inflation. Wikipedia, "Reagonomics," online: <http://en.wikipedia.org/wiki/Reaganomics>.

[7] There is a full discussion of the background of this crisis on Wikipedia, which also lists many books and articles on the subject. See Wikipedia, "Savings and loan crisis," online: <http://en.wikipedia.org/wiki/Savings_and_loan_crisis>.

[8] In economic theory, moral hazard is a situation in which a party insulated from risk behaves differently from how it would behave if it were fully exposed to the risk. Moral hazard arises because an individual or institution does not take the full consequences and responsibilities of its actions, and therefore has a tendency to act less carefully than it otherwise would, leaving another party to hold some responsibility for the consequences of those actions. For example, a person with insurance against automobile theft may be less cautious about locking his or her car, because the negative consequences of vehicle theft are (partially) the responsibility of the insurance company. Wikipedia, "Moral hazard," online: <http://en.wikipedia.org/wiki/Moral_hazard>.

[9] Although the potential of Greek default has been in the news recently as well as the possibility of U.S. default before Congress allowed increased borrowing limits, the fact is there have been many sovereign defaults in this century, even in the U.S.

[10] See Wikipedia, "Long-Term Capital Management," online: <http://en.wikipedia.org/wiki/Long-Term_Capital_Management>.

[11] A full discussion of the Dot-com Bubble, including its extent and consequences, and a list of the many companies which went bankrupt or disappeared following the collapse is available at: Wikipedia, "Dot-com bubble," online: <http://en.wikipedia.org/wiki/Dot-com_bubble>.

[12] See The Guardian, "Star of dotcom boom is arrested" (24 April 2003), online: <http://www.guardian.co.uk/media/2003/apr/24/business.newmedia>;

Frank Quatrone, formerly of Credit Suisse, is charged and convicted of obstruction of justice. After two trials and on the eve of a third trial, he was cleared and his conviction and lifetime bar from working in the securities industry set aside. Others were not so fortunate, such as Arthur Anderson CA, one of the five largest accounting firms in the world, which dissolved due to its negligence in auditing Enron and Kenneth Lay and Andrew Fastow among others went to jail. See Wikipedia, "Enron scandal," online: <http://en.wikipedia.org/wiki/Enron_scandal>.

[13] To learn more about this history, one can listen to podcasts on NPR's "Planet Money," with such colorful topics such as "Return of the Toxie." See National Public Radio, "Planet Money," online: <http://www.npr.org/blogs/money/>.

[14] Michael Lewis, *The Big Short: Inside the Doomsday Machine*, (New York: WW Norton & Co, 2010).

[15] *Ibid.* p. 62.

[16] James B. Stewart, *Den of Thieves*, (Simon & Schuster, 1991).

[17] Wikipedia, "Michael Milken," online: <http://en.wikipedia.org/wiki/Michael_Milken>.

[18] The buyers of subprime mortgages (via CDOs) included Caisse Populaire, the largest pension fund in Canada (for Quebec), the New York Pension Plan, and many others. See Financial News, "Canada's biggest pension plan takes $503m sub-prime hit" (9 November 2007), online: <http://www.efinancialnews.com/story/2007-11-29/canadas-biggest-pension-plan-takes-sub-prime-hit>; Subprime Losses, "Carlyle Group Pays $20 Million in NY Pension Fund Probe" (19 May 2009), online: <http://www.subprimelosses.com/blog/index.php/category/pension-funds/>.

There has been a virtual explosion of litigation arising out of these investments. See Ralph Deeds, "Master Liquidity Enhancement Conduit Floyd Norris High-Low Finances," online: <http://ralphdeeds.hubpages.com/hub/Master-Liquidity-Enhancement-Conduit-Floyd-Norris-High--Low-Finances>. Note that the beneficiaries of these pension plans are individuals who depend on their pensions for their living expenses in retirement.

[19] See The D & O Diary, "Can Investors Blame the Rating Agencies for Mortgage Investment Losses?" (12 November 2007), online: <http://dandodiary.blogspot.com/2007/11/can-investors-blame-rating-agencies-for.html>. This article deals with the rating agencies and the legal action

against them; it also discusses the claim that they were protected in the U.S. under the First Amendment.

See also Hedge Funds Review, "Rating agencies come under fire after subprime fiasco" (11 January 2010), online: <http://www.hedgefundsreview.com/hedge-funds-review/feature/1586077/rating-agencies-subprime-fiasco#ixzz1jvjUxUfN>.

We have yet to see how the litigation against the rating agencies will evolve. Although the argument that the rating agencies are in effect "underwriters" has met with no success in the courts, a novel argument using New Mexico law has permitted a class action to move forward against Standard and Poors:

In truth, it is difficult to see from a logical or moral perspective why the rating agencies, paid by the issuers, and negligent or worse in their activities, do not owe a compensable duty of care to the investors. It is hard to believe the authors of the First Amendment would have intended that result. I am not aware of any Canadian litigation on this issue.

[20] Lewis writes about the Credit Rating Agencies in his book, *The Big Short*, *supra* note 14.

[21] See Wikipedia, "Financial Crisis of 2007," online: <http://en.wikipedia.org/wiki/Financial_crisis_of_2007%E2%80%932010>.

[22] The exact type of hedge used in the Barclay case was a CDS, also know as a synthetic asset. Synthetic assets are defined as the combination of securities and/or assets in such a way that they produce the same financial effect as the ownership of an entirely different asset would. For example, selling a put option and buying a call option on a commodity produces the same financial effect as actually owning the underlying commodity.

[23] Warren Buffet warned of this in 2002 in his letter to investors:

> *We try to be alert to any sort of mega-catastrophe risk, and that posture may make us unduly appreciative about the burgeoning quantities of long-term derivatives contracts and the massive amount of uncollateralized receivables that are growing alongside. In our view, however, derivatives are financial weapons of mass destruction, carrying dangers that, while now latent, are potentially lethal.*

A less apparent problem with credit default swaps was the ability of the insurer, the issuer of the swaps, to pay if called upon to do so. In the Devonshire case, Devonshire was a conduit without resources and therefore had to post security, but the security was only a fraction of the loss if the underlying security defaulted. The investor might be told "the position we have is hedged" or "we have CDS as protection," but a deeper analysis might demonstrate that the protection was illusory.

[24] There have been very few criminal cases arising out of the Subprime Crisis. See The New York Times, "Tracking Financial Crisis Cases," online: <http://www.nytimes.com/interactive/business/financial-crisis-cases.html>.

[25] Canadian banks fared much better than those in most countries during the economic crisis and there was never any fear that major Canadian banks would fail.

[26] The details of this restructuring are beyond the scope of this article. See Ernst & Young, "Asset-Backed Commercial Paper ("ABCP")," online: <http://documentcentre.eycan.com/Pages/Overview.aspx?SID=35>.

[27] In discussions with Tom Curry, lead counsel for Devonshire, he indicated that the Devonshire default notice to Barclays alleged the amount paid was insufficient as well. The exact contents of the Devonshire default notice were not in issue as the intent of the notice was clearly to end the arrangement.

[28] The issue of "market disruption" has recently come up in the context of Greek bonds. See *The Globe and Mail*, (29 October, 2011) B9: "European Officials have deemed the plan [for holders to take a 50 per cent loss] to be voluntary on the part of the bondholders…it should not trigger a default. The ISDA, which oversees the credit default swaps market, *including $3.7 billion (US) worth of insurance on Greek Bonds, agrees*."

Note that when the meltdown occurred in the U.S. in 2008, there were many European Banks that held swaps issued by AIG. These banks, along with U.S. holders, received full payment.

[29] The damage calculations are beyond the scope of this paper and are very specific to the agreements entered into between the parties. There is extensive comment on damages in the Decision.

[30] A partner of Lenczner Slaght, Toronto, Ont.

[31] *Barclays*, *supra* note 1 at para. 43. Newbould is more critical in latter parts of the decision.

[32] See *Hexion v. CSDB*, N.Y.S.C. No. 0811455 (29 October 2008) as an illustration of a hedge fund attempting to get out of a merger agreement by a scheme that was devious but ultimately failed to achieve a desired result, again in part because of the lack of credibility of witnesses (in that case, including tainted experts).

[33] *Barclays Bank PLC v. Devonshire Trust (Trustee of)* (27 February 2009), CV-09-370103 (Ont. Sup. Ct.).

[34] *Barclays supra* note1.

[35] *Ibid*. at para. 82.

[36] *Ibid*. at paras. 84-110.

[37] *Ibid*. at para. 308.

[38] Quaere whether, absent the finding of bad faith, Newbould would have found that Barclays had repudiated the Agreement. If Barclays had not repudiated, what effect would this have on Devonshire's Default Notice?

[39] See *Hexion*, supra note 32 re: reliance on own wrongdoing.

[40] The consequence of this seems vague; what exactly does "not being able to rely on the notice" mean? Does it mean that, in effect, the notice is deemed not given? That is not likely the meaning because as a result of the notice, Barclays has been found to have repudiated the ISDA Agreement. I think it probably means that Barclays cannot rely on it as notice to Devonshire of termination whether or not, in the absence of bad faith, it was valid.

INVITATION TO OUR READERS

- **Have you written an article that you think would be appropriate for the *National Insolvency Review*?**

AND/OR

- **Do you have any ideas or suggestions for topics you would like to see featured in future issues of *National Insolvency Review*?**

If any of the above applies to you, please feel free to submit your articles, ideas and suggestions to the General Editor, Justin Fogarty at:

nir@lexisnexis.ca

We look forward to hearing from you.