The LIBOR Scandal and Litigation: How the Manipulation of LIBOR Could Invalidate Financial Contracts

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The LIBOR Scandal and Litigation: How the Manipulation of LIBOR Could Invalidate Financial Contracts

I. INTRODUCTION

On December 19, 2012, UBS agreed to pay $1.5 billion to U.S., U.K., and Swiss authorities for intentionally manipulating the London Interbank Offered Rate ("LIBOR"). This record-setting fine settles an investigation by regulatory authorities into a massive scheme operated by UBS traders to move LIBOR in directions beneficial to the bank. On June 27, 2012, Barclays pledged to pay a total of $453 million in fines to the Commodities Future Trading Commission (CFTC), the U.S. Justice Department, and the British Financial Services Authority (FSA). This fine settled the probe into Barclays's manipulation of LIBOR. These regulatory fines, however, represent just the beginning of the potential fallout from the LIBOR scandal. The fines have set a precedent for the fifteen other banks involved in setting LIBOR ("reference banks"), and have set the stage for borrowers around the world to pursue a wide range of legal remedies. In fact, it took Berkshire Bank less than a month after the Barclays fine to file a massive class action suit in the Southern District of New York against


2. Id.


5. Gallu, supra note 3 ("'We expect that the cost of lawsuits related to LIBOR manipulation will dwarf the fines imposed on Barclays,' said Sandy Chen, a banks analyst at Cenkos Securities Plc in London, who is 'penciling in multi-year provisions that could run into the billions.'").

6. Id.
the sixteen reference banks.\(^7\) The Federal Housing Finance Agency has urged Fannie Mae and Freddie Mac to sue the reference banks now that the findings of the UBS settlement have come to light.\(^8\) The Berkshire Bank suit, and others like it, could result in enormous awards of compensatory and punitive damages. Additionally, the LIBOR scandal could allow debtors and other borrowers to invalidate financial contracts and swap deals that use a fraudulently established LIBOR as the reference rate.

The public reaction to the LIBOR scandal has spurred government and regulatory officials into detailed examinations of the LIBOR rate setting process that will pave the way for litigants. Politicians turned the LIBOR scandal into political fodder for the 2012 presidential election race.\(^9\) The House Financial Services Committee has repeatedly criticized U.S. Treasury Secretary Timothy Geithner for his handling of the LIBOR scandal, despite his assertions that he warned the British and U.S. regulators once he knew of the manipulation.\(^10\) In the face of scrutiny from politicians and angry consumers, the CFTC, the U.S. Justice Department, the FSA, and attorneys general have moved quickly to gather the information necessary to hold manipulators accountable. Investigations by government and regulatory officials will be particularly useful to private litigants because regulatory conclusions are admissible in private litigation under Federal Rule of Evidence 803(8).\(^11\)

Sixteen banks submit quotes to Thomson Reuters for the purpose of setting LIBOR.\(^12\) The reference banks are Barclays, Bank of

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10. Id.
11. Fed. R. Evid. 803(8)(A) (“A record or statement of public office [is not excluded by the rule against hearsay] if . . . (iii) in a civil case or against the government in a criminal case, factual findings from a legally authorized investigation . . .”).
12. Factbox: Banks drawn into Libor rate-fixing scandal, REUTERS (July 11, 2012), http://www.reuters.com/article/2012/07/11/us-banking-libor-panel-idUSBRE86A0P020120711 [hereinafter Factbox]. In the wake of the financial crisis, the BBA has changed its reference banks for USD LIBOR. The current panel is comprised of eighteen banks and includes Bank of America, Bank of Tokyo-Mitsubishi UFJ Ltd.,
America, Bank of Tokyo-Mitsubishi UFJ, Citigroup, Credit Suisse, Deutsche Bank, Lloyds, HSBC, HBOS (now a subsidiary of Lloyds), JPMorgan, Rabobank, RBC, RBS, UBS, WestLB, and Norinchukin.\textsuperscript{13} Each of these reference banks has faced some form of LIBOR-related inquiry. Bank of America has received subpoenas and requests for information from the Department of Justice, the CFTC, and the FSA in the wake of the LIBOR scandal.\textsuperscript{14} The FSA is also currently investigating Bank of Tokyo-Mitsubishi UFJ.\textsuperscript{15} New York and Connecticut authorities have sent subpoenas to every single reference bank.\textsuperscript{16} RBS has entered into negotiations with regulators to reach a settlement similar to the one reached by UBS and Barclays.\textsuperscript{17} Lloyd’s has received subpoenas from various British authorities regarding its involvement in the LIBOR scandal.\textsuperscript{18} Rabobank is cooperating with various government authorities in their investigation into the LIBOR scandal.\textsuperscript{19} WestLB, now defunct, is also complying with regulatory requests for documentation.\textsuperscript{20}
These investigations have also triggered private litigation. Guardian Care Homes, a residential care home corporation that holds two swap agreements, is leading the charge in Britain with a suit against Barclays.\textsuperscript{21} In the United States, The Berkshire Bank class action, ongoing in the Southern District of New York, will create a template for U.S. litigants who are now waiting in the wings.\textsuperscript{22} The LIBOR scandal presents an opportunity for affected counterparties to possibly recover funds from banks using contract claims. LIBOR plaintiffs have pursued various causes of action — fraud, breach of the implied covenant of good faith and fair dealing, antitrust, and unjust enrichment.\textsuperscript{23} These claims, combining tort and contract law, provide attractive pathways for recovery on LIBOR-related contracts. However, LIBOR plaintiffs have not alleged mutual mistake and frustration of purpose claims.

Litigants will likely have success using contract claims to recover on various financial contracts that used LIBOR as a crucial benchmark. Notwithstanding the barriers to recovery posed by the LIBOR calculation method itself, litigants can overcome these barriers by using information published in detailed analytical studies and findings from regulatory agency investigations. For example, a regulatory agency may find emails and text messages between UBS traders planning the faulty quote of the day. Findings such as these will increase the likelihood of recovery for private plaintiffs.\textsuperscript{24} The difficulties of proving collusion will more than likely prevent successful antitrust claims. As such, plaintiffs should look to fraud, frustration of purpose, breach of the implied covenant of good faith and fair dealing, and mutual mistake for improved chances of recovery.

This Note begins with observations on the calculation of LIBOR. Part III looks at the incentives for altering this extremely important rate and some of the analytical studies conducted on the apparent manipulation. Then, Part IV discusses the wide variety of

\begin{footnotesize}
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\item \textsuperscript{21} Matt Scuffham, Barclays Libor case to go to trial, Reuters (Oct. 29, 2012), http://www.reuters.com/article/2012/10/29/us-barclays-libor-idUSBRE89S0V120121029.
\item \textsuperscript{22} Jean Eaglesham, New York Lender Files Libor Lawsuit, Wall St. J. Online (July 30, 2012), http://online.wsj.com/article/SB10000872396390444860104577557052131047024.html.
\item \textsuperscript{23} Am. Compl. at 97, In Re Libor-Based Financial Instruments Antitrust Litigation, No. 11-MD-2262-NRB (S.D.N.Y. 2012) ; Class Action Compl., \textit{supra} note 7.
\item \textsuperscript{24} Enrich & Eaglesham, \textit{supra} note 1.
\end{itemize}
\end{footnotesize}
claims available to LIBOR plaintiffs, and the likelihood of recovery for each category of claims. The Note then examines barriers to recovery, and concludes with observations on the road ahead for LIBOR litigation.

II. CALCULATING LIBOR

LIBOR is calculated every day around 11:00AM GMT.25 Sixteen reference banks individually submit estimates of how much interest they would be charged to borrow money from other banks and institutions to the British Bankers Association (BBA).26 Each reference bank submits a different estimate for various borrowing periods and currencies used in interbank financing.27 These estimated quotes are non-binding, and do not oblige the submitting bank to actually obtain loans at that rate.28 As of 2008, a separate LIBOR was calculated for fifteen different borrowing periods and ten currencies.29 Thomson Reuters compiles these quotes and calculates the various LIBOR rates.30 The middle eight quotes are averaged to create each specific LIBOR for the day.31

During the most recent financial crisis, the amount of interbank lending decreased significantly.32 The reference banks did not extend short-term overnight credit to each other frequently enough to come up with accurate, meaningful “quotes” for submission to the BBA.33 Credit quality fluctuations among reference banks and a “deterioration in liquidity” contributed to speculative quotes.34 The quotes became more

27. Id.
29. Id. at 69.
30. De La Merced, supra note 25.
33. Id.
34. Gyntelberg & Wooldridge, supra note 28, at 71 (arguing that the mechanism for
and more speculative as the financial crisis worsened.\textsuperscript{35} For sophisticated market observers, it became increasingly apparent that the quotes underlying LIBOR were really the products of guesswork or, more troublingly, conscious manipulation.\textsuperscript{36} As the quotes continued to diverge from default insurance costs, concerns over the rate’s accuracy prompted analytical studies and eventually spurred investigations.\textsuperscript{37}

III. WHAT LIBOR MANIPULATION MEANS FOR THE MARKETS

A. Reputational Incentives for Misreporting

Reference banks can profit from an artificially heightened or lowered LIBOR in different ways.\textsuperscript{38} Quoting a lower rate makes a bank appear stronger, thereby assuring its customers that the bank is in a strong borrowing position and viewed as creditworthy by peer institutions.\textsuperscript{39} In the wake of liquidity insolvencies among several banks, including Northern Rock and Bear Stearns, reference banks could have underreported interbank rate quotes in an effort to combat the reputational risks that accurate quotes could have presented during the financial crisis.\textsuperscript{40} Despite soaring credit default insurance costs,
banks continued to underreport interbank borrowing rates in an effort to assuage market fears over their strength and stability.  

B. Using Manipulation to Profit from Various Financial Contracts

Another incentive for banks to artificially suppress LIBOR hinges on each bank's portfolio exposure to LIBOR as a reference rate. Interest rate swaps provide an excellent example. Interest rate swaps use LIBOR more frequently than any other reference rate. In most interest rate swaps, one party exchanges a fixed rate payment in return for a variable interest rate payment. Interest rate swaps allow investors to manage exposure to varying interest rates or lock in a lower interest rate than otherwise possible. These contracts are one of the primary methods employed by corporations, municipalities, and other investors to hedge against fluctuations in interest rates and fix interest payments over a period of time. The cash flow of an interest rate swap hinges, to a large degree, on LIBOR.

The Payer and the Receiver are the two parties to an interest rate swap. The Payer sets a notional value with the Receiver. The Payer pays a fixed interest rate, agreed upon by the parties, to the Receiver. The Receiver, in return, pays a floating or variable rate to the Payer. If "f" is the fixed rate, "Lt" is the variable rate, "t" is the time period of the

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41. Mollenkamp & Whitehouse, supra note 37. On January 1, 2007, Citigroup's CDS spread was approximately five points below its one year LIBOR quote. By January 2009, Citigroup's CDS spread and its one year LIBOR quote converged just above two. Over the course of 2009, Citigroup's CDS spread skyrocketed more to almost seven points above its one year LIBOR quote. It took less than three years for this historical relationship to reverse by almost twelve points. Snider & Youle, supra note 31, at 19 (Figure 1); Ansgar Belke & Christian Gokus, Volatility Patterns of CDS, Bond and Stock Markets Before and During the Financial Crisis; Evidence from Major Financial Institutions, 243 RUHR ECONOMIC PAPERS, Feb. 2011, at 9.

42. Snider & Youle, supra note 31, at 10.

43. Id. at 9.


45. Id.


47. The notional value is merely a benchmark agreed upon by the parties and, like a principal, is never actually exchanged between the parties. Snider & Youle, supra note 31, at 10 n. 10.
contract, and "V" is the notional value, then the Payer receives \((Lt-f)V\) and the Receiver receives \((f-Lt)V\). A higher variable rate results in a better return for the Payer, while a lower variable rate results in a better return for the Receiver.\(^{48}\) If Bank ABC has a large amount of interest rate swaps outstanding in a given quarter, any fluctuation in LIBOR will have serious implications for Bank ABC’s large portfolio exposure to LIBOR.\(^{49}\)

Assume that Bank ABC has entered into LIBOR-based interest rate swaps with a total notional value of $100 million as the Receiver. The term on these swaps is set to end at the conclusion of the current quarter. The fixed interest rate on these swaps is three percent, and the fluctuating rate is based on the three-month LIBOR. During this quarter, for whatever reason, LIBOR has continued to decrease and has reached 2.7825.\(^{50}\) Bank ABC has made $21,750,000 on its swap contracts from their potentially defrauded counterparties, in this quarter alone, because of the slightly decreased LIBOR rate.

The analysis of Connan Snider, an Economics Professor at University of California, Los Angeles, and Thomas Youle, a doctoral student in economics at the University of Minnesota, has shown that once the financial crisis was well underway in 2007, some reference banks calculated their quotes with the intention of positively affecting their particular portfolio exposure.\(^{51}\) Snider and Youle released their study in 2010, and it has since been a key resource for litigants.\(^{52}\) Assume Bank ABC has entered into a large amount of swaps as a Receiver. As a Receiver in the foregoing example, Bank ABC will profit on its swaps if LIBOR takes even a slight dip. Thus, Bank ABC has a strong incentive to influence LIBOR downward. Theoretically, because LIBOR is the average of the middle eight quotes submitted to the BBA, a bank seeking to influence the rate in its favor in the strongest possible way would attempt to set its quotes for the day at the

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49. See id.
51. Snider & Youle, supra note 31, at 10. This is the careful conclusion of the study.
52. See, e.g., Class Action Compl., supra note 7, at 6 (citing to Snider and Youle, supra note 31).
Bank ABC, seeking to lower the LIBOR, aims for the fourth lowest quote in order to bring the overall LIBOR downward. A quote at this pivotal point, Snider and Youle argue, will have the desired impact on LIBOR while avoiding a BBA investigation into potential manipulation. Bank ABC’s daily quotes, aimed at the fourth lowest quote, could significantly lower the LIBOR, resulting in a profit for Bank ABC and losses for the Payers who entered swap agreements with the Bank.

If reference banks actually acted on this incentive and pursued this strategy, we would expect to see bunching of quotes around the fourth lowest and twelfth highest quotes every day. Snider and Youle calculated the density of the quotes that Citigroup, Bank of America, JPMorgan, and WestLB submitted to the BBA. They found that each bank’s quotes clustered significantly around the fourth lowest quote for the day. Citigroup and Bank of America consistently submitted quotes identical to the fourth lowest quote. JPMorgan clustered its quotes slightly below the fourth lowest quote, while WestLB clustered its quotes slightly above the fourth lowest quote. This clustering behavior is consistent with a desire on the part of Bank of America and Citigroup to lower the overall LIBOR, while WestLB does not appear to have such a desire.

In May of 2008, Carrick Mollenkamp and Mark Whitehouse, economic reporters for the Wall Street Journal, conducted a similar analysis of LIBOR, and compared LIBOR to its traditional indicator, the default-insurance market. The analysis found the two rates usually rose and fell in tandem. However, as the cost of default insurance soared in the face of worries over bank closures, LIBOR failed to soar

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54. Id. at 6.
55. Id.
56. See id. at 10.
57. Id. at 2.
58. Id. at 23.
59. Id.
60. Id.
61. Id.
62. Id. at 7.
63. Mollenkamp & Whitehouse, supra note 37.
64. Id.
along with it. The analysis does not purport to prove any intentional manipulation, and cites reasons similar to the Snider and Youle study for the divergence—dearth of actual interbank lending, accessibility of Federal Reserve loans, high rates of customer deposits in some banks—but does note a worrying trend in the first four months of 2008. During these months, all sixteen reference banks reported a three-month rate which remained, on average, within a range of .06%. These extremely similar quotes from each bank directly contradicted the default-insurance market data, which compared the financial health of the reference banks. For example, on March 10, 2008, the cost of default insurance for WestLB was twice the cost of default insurance for Credit Suisse. Both banks reported the same LIBOR the next morning.

The Mollenkamp and Whitehouse study calculated an alternative LIBOR based on the default-insurance market and its historical correlation to LIBOR. The study then compared this created rate to the actual LIBOR rate during the months leading up to the collapse of Bear Sterns. During these months, the cost of default insurance rose sharply, but the actual LIBOR declined. The study’s created rate differs from the actual LIBOR quotes submitted by .87% for Citigroup, .7% for WestLB, .57% for HBOS, and .42% for UBS. Royal Bank of Canada reported rates closest to the study’s created rate. The average difference between the study’s created rate and the actual LIBOR for this period was .25%. Following a BBA review of LIBOR’s accuracy in mid-April, this average difference dropped to .15%. This study’s creation of an alternative rate, keyed to another market with a historical relationship to LIBOR, will play a crucial role.

65. Id.
66. Id.
67. Id.
68. Id.
69. Id.
70. Id.
71. Id.
72. Id.
73. Id.
74. Id.
75. Id.
76. Id.
77. Id.
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in the calculation of damages in litigation.

LIBOR manipulation also has a significant impact on the municipal bond market. This market, comprised of debt offerings from states, cities, universities, and nonprofits, sees relatively conservative investing by municipalities attempting to reduce borrowing costs in the least-risky manner possible.\(^7\) Municipal bonds “combine a variable rate bond with an interest rate swap so that if all works as planned, borrowers end up with fixed rate financing, at a lower cost of borrowing.”\(^8\) These bonds are designed to protect borrowers from interest rate fluctuations so that municipalities can obtain predictable funding for long-term public works, such as transportation systems.\(^9\) The variable rate in a great deal of the interest rate swaps underlying these municipal bonds was LIBOR.\(^10\)

LIBOR manipulation, by altering the underlying interest rate swaps, prevented the swaps from pairing with the variable rate bond to produce the fixed rate sought by municipalities.\(^11\) LIBOR manipulation thus had a ripple effect throughout the municipal bond market and caused several municipalities, like the city of Baltimore, to pay more on their bonds than originally anticipated.\(^12\) Some municipalities are paying above-market rates as high as 6% in return for payments from banks as low as .5%.\(^13\) These bonds are extremely difficult to refinance.\(^14\) New York State has paid $243 million in order to get out of debt deals containing swap agreements.\(^15\) Municipalities vary in their overall use of municipal bonds with underlying LIBOR-tied interest rate swaps. North Carolina, for example, has over $1.3 billion in two

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79. Interview with Alexander Arapoglou, supra note 78.


82. Interview with Alexander Arapoglou, supra note 78.

83. Popper, supra note 81.

84. Morgenson, supra note 80.

85. Id.

86. Id.
interest rate swap agreements. LIBOR manipulation directly affects the state’s treasury.

LIBOR is the reference rate for a vast collection of other financial instruments. Many investments, thought to be relatively stable stores of value, saw diminished returns because of understated LIBOR. For instance, income from traditional money market funds lost as much as 2% due to LIBOR manipulation. Almost half of all adjustable-rate mortgages in the United States use LIBOR as the reference rate. Analysts have determined that the holder of a $100,000 mortgage was $50 to $100 worse off every month because of LIBOR manipulation. LIBOR manipulation may have cost Fannie Mae and Freddie Mac as much as $3 billion, according to an unpublished report from the Federal Housing Finance Agency.

Pension funds also use the LIBOR rate in order to protect against risks and lock in predictable returns. Pensions hold floating rate bonds with payments based upon LIBOR. Consequently, the return rates for pensions are reduced as LIBOR is lowered. This leaves pensioners and companies in the lurch to make up the difference between the expected and actual returns. Determining the overall losses or gains from LIBOR manipulation in any given fund is a complicated process because of various hedging strategies employed by

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89. Interview with Alexander Arapoglou, supra note 78.
90. Gensler, supra note 46.
92. Enrich & Eaglesham, supra note 1.
93. Popper, supra note 81.
95. Interview with Alexander Arapoglou, supra note 78 (arguing that these losses, somewhat removed from the forefront of LIBOR litigation, are perhaps the most difficult to recover).
96. Id.
fund managers. CalPERS, as well as several other managers of pension funds, are conducting reviews to determine the overall effect that LIBOR manipulation made on their funds.

Seventy percent of the U.S. futures market uses LIBOR as the reference rate. Lenders often use LIBOR as a baseline interest rate before adjusting on a borrower-specific basis. Approximately half of variable-rate student loans use LIBOR. Some estimates indicate that $800 trillion in loans and securities are tied to LIBOR. The LIBOR scandal has also exposed banks to regulatory and litigation losses, hurting shareholders by dropping stock prices.

This pervasive use of LIBOR creates an impressive array of potential litigants. Any entity on the losing side of a LIBOR-related contract could seek relief for damages resulting from LIBOR manipulation. Commentators estimate the potential losses from LIBOR-related litigation range from $6 billion to $35 billion, and could potentially even reach $1 trillion.

98. Id.
99. Gensler, supra note 46.
101. Id. (showing the progression of the scandal in graphical form).
102. Barker, supra note 94.
103. See, e.g., Andrew Harris et al., Wall Street Bank Investors in Dark on Libor Liability, BLOOMBERG (July 5, 2012, 3:44 PM), http://bloomberg.com/news/2012-07-05/wall-street-bank-investors-in-dark-on-libor-liability.html (showing that Barclays stock dropped 16% the day after the regulatory fine was announced).
IV. CLAIMS AVAILABLE TO LIBOR PLAINTIFFS

A. Antitrust Claims

The composite nature and overall downward trend of LIBOR has compelled some plaintiffs to pursue antitrust claims against the reference banks collectively. In order to prevail on an antitrust claim, plaintiffs face the difficult burden of proving collusion on the part of the banks. In an antitrust action, plaintiffs must allege an actual agreement among the market competitors to restrain competition in a specific market. Once plaintiffs allege sufficient facts to overcome this initial test, they must allege enough bank action to constitute a "restraint of trade." A restraint of this sort violates section 1 of the Sherman Act.

In a motion to dismiss antitrust allegations filed on June 29, 2012, Bank of America and Credit Suisse ("Defendants") outlined the weaknesses of antitrust claims in the LIBOR context. In support of their motion, Defendants argued that reference banks may have individually attempted to manipulate LIBOR, but there is little evidence that they actively colluded in order to influence it in one direction. Furthermore, LIBOR is not the "price" of anything and there is no market in regard to reporting rates. According to the Defendants, false reporting is not "a competitive act, and does not restrain trade in any market." If the individual quotes were merely factored into an index, not a price, then the quotes could not have restrained the trade of anything.

The specific proof of collusion and price-fixing needed to win antitrust claims will make antitrust claims extremely difficult for LIBOR plaintiffs. The UBS settlement has provided antitrust

106. Id. This initial test is known as the Twombly test. See Bell Atlantic Co. v. Twombly, 550 U.S. 544 (2007).
110. See id. at 10.
111. Id. at 7.
112. Id.
113. Id.
114. See Eaglesham, supra note 22.
claimants with a potential source of valuable evidence. Regulators have
determined that Thomas Hayes, the UBS trader at the center of the
LIBOR manipulation, worked with traders at four other banks in order
to rig the rate.115 Hayes also worked with outside brokers, who in turn
worked with other reference banks to help set the LIBOR quote for the
day.116 In an email from one of these brokers, other reference banks
were characterized as “sheep” that would hopefully just fall in line with
the quotes of the banks rigging the rate.117 If available, communications
similar to this email will provide valuable ammunition to antitrust
claimants seeking to paint a picture of collusion across the reference
banks.

B. Fraud Claims

Although fraud is a cause of action in both tort and contract law,
many states do not distinguish between the two versions of the claim.118
A fraud claim must allege five elements: (1) representation, (2) falsity,
(3) scienter, (4) deception, and (5) injury. In contract law, damages are
generally designed to move the aggrieved party forward and give the
aggrieved party the benefit of its bargain. Successful fraud plaintiffs, on
the other hand, are restored to the status quo ante, instead of being
awarded the lost benefit of the bargain.119 However, most jurisdictions
mix tort and contract law to supplement these restitutionary contract
damages with consequential tort damages, essentially compensating the
aggrieved party for the loss of the bargain.120 Additionally, when a
party has misrepresented a fact that the contract requires the party to
disclose, punitive damages may be awarded.121 Therefore, fraud claims,
whether in tort or contract law, provide a sophisticated measurement of
damages with the potential for large awards.

The Southern District of New York has recently consolidated a

115. Enrich & Eaglesham, supra note 1.
116. Id.
117. Id.
118. 7 ARTHUR L. CORBIN, CONTRACTS § 28.13 (Joseph M. Perillo et al. eds., 2002).
119. Id.
120. Id.
host of LIBOR lawsuits into one massive class action. Berkshere Bank and a class of similarly situated banks and holding companies brought a claim under the common law tort of fraud, alleging that the banks submitted materially false quotes to the BBA with the understanding that those quotes would be disseminated throughout the financial services industry. The complaint states that the banks succeeded in bringing LIBOR down, thereby enhancing their profits. The complaint further alleges that the banks knew of the falsity of their quotes, and recklessly disregarded actual interbank rates.

Actual interbank loans were uncommon during the financial crisis. Proving that banks “recklessly disregarded the falsity” of their quotes during these uncertain times is a significant barrier to recovery. Proving reckless disregard will present similar challenges to those faced by antitrust plaintiffs, who will have to allege a specific degree of manipulation.

For a successful fraud claim, the class must prove that the reference banks intended to induce the plaintiffs’ reliance on the manipulated quotes. The class has alleged that the reference banks’ “only” reason for issuing false quotes was to induce the BBA to rely on those quotes in setting LIBOR. This is a calculated, strategic decision on the part of the class. On one hand, it almost looks as if the class is suing on behalf of the BBA. The class could have trouble connecting a reference bank’s quote to the BBA, to the LIBOR composite rate, and to the investments in question, if they alleged that the banks intended the class to rely on the quotes. Ultimately, the class relied on LIBOR. The individual quotes were small parts of the composite rate, but were the underlying determinants of LIBOR. Reference banks should not avoid liability simply because they indirectly, instead of directly, manipulated LIBOR.

The class contends that it relied on these false quotes by relying

122. See Chris Bruce, New York Bank Files Class Suit on LIBOR, Says Fraud by 21 Firms Hurt Interest Income, BNA BANKING REPORT, July 31, 2012.
123. Class Action Compl., supra note 7, at 12.
124. Id.
125. Id.
126. Id.
127. See supra Part IV. A.
128. Id. at 13.
Each member of the class took calculated risks and bargained for investment returns based on LIBOR as they knew it, not on the assumption that a manipulated rate would continue to be depressed. The depressed LIBOR formed the basis for interest rate calculations, and class members issued or received payments based on these calculations. The critical role LIBOR plays in these calculations firmly establishes reliance by the class members. Furthermore, this reliance on LIBOR was both justifiable and reasonable because it was the pervasive norm throughout the financial services industry. The pervasiveness of LIBOR and its global use certainly establishes the element of "justifiable and reasonable" reliance.

The reduced return the class members received on their various financial contracts constitutes the injury in this claim. A depressed LIBOR results in reduced returns for the borrowing class members, which constitutes injury in fact. The trouble with this element is, as discussed previously, that determining the extent of those reduced returns or the amount LIBOR was actually altered is extremely difficult. Defendant banks can attack the lack of specificity in this element and expose its weaknesses. The court, however, will have to determine what constitutes a sufficient allegation of injury in fact for fraud claims to proceed.

The class then avers that the injury it suffered was proximately caused by the banks' manipulated quotes, and that LIBOR would not have been altered but for the banks' conduct. The manipulated quotes must have had an impact on the overall LIBOR "[b]ecause of the mechanical nature of the BBA's calculation." This is a two-step causation chain, because the class members then link the returns on their LIBOR-tied contracts to the BBA's calculation of LIBOR.

The class imputes the defendant banks with knowledge of the

129. Id.
130. See id.
131. See id.
132. Id.
133. Id.
134. See id.
135. Id.
136. Id.
137. Id.
entire fraud, alleging that “due to their own transactions in USD LIBOR-tied loans and their analyses of credit markets and financial services firms, Defendants would certainly have understood that falsifying USD LIBOR quotes would impact adjustable rate loans issued by other lenders.” This allegation, by highlighting the expertise of the Defendants, does a good job of tying the fraud claim together.

Fraud is the most straightforward claim for borrowers and other parties who use LIBOR. Manipulating LIBOR, whether to improve the market perception of the bank or profit from large portfolio exposure to the rate, is “textbook securities fraud.” Civil and criminal penalties can flow from this fraud, and it should prove a fruitful ground for litigants. Moreover, the UBS settlement has brought several potential pieces of evidence to light for fraud claimants. Thomas Hayes, the alleged ringleader of UBS’s efforts to rig LIBOR, has been arrested by British authorities and charged by U.S. prosecutors with fraud. The regulatory findings include attempts by UBS to bribe employees at brokerage firms to act as middlemen and coordinate LIBOR submissions for various reference banks. The findings from the UBS settlement also include knowledge and involvement of senior management, possibly imputing them and the institution as a whole with scienter. The U.S. Department of Justice has decided not to press charges, but this will not prevent private litigants from using these findings in their pursuit of civil damages.

C. Breach of Good Faith and Fair Dealing Claims

Another available claim is the breach of the implied covenant of good faith and fair dealing. LIBOR plaintiffs allege that the reference banks breached the implied covenant of good faith and fair dealing in

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138. Id.
139. Interview with Alexander Arapoglou, supra note 78.
141. Enrich & Eaglesham, supra note 1.
142. Id.
143. Id.
144. Id.
various financial contracts by manipulating the rate to the advantage of
the reference banks. State law governs the implied covenants of good
faith and fair dealing.\textsuperscript{145} In Delaware, a popular jurisdiction for
corporate litigants, these covenants require that contract parties "act
reasonably upon contractual language that is on its face reasonable."\textsuperscript{146}
Courts often imply such a covenant in order "to protect the spirit of an
agreement when, without violating an express term of the agreement,
one side uses oppressive or underhanded tactics to deny the other side
the fruits of the parties' bargain."\textsuperscript{147}

The court must first determine the "spirit" of the contract by
looking to its express terms.\textsuperscript{148} After deciding the spirit of the contract,
the court attempts to "determine the terms that the parties would have
bargained for" if they had foreseen the circumstance which caused the
litigation.\textsuperscript{149} The court then implies the "extrapolated term" into the
contract in an attempt to resolve the dispute.\textsuperscript{150} If a party has breached
the extrapolated term, the party has breached the contract.\textsuperscript{151} The court
will fashion relief for a breach of an extrapolated term in the same
manner as a breach of an express term.\textsuperscript{152}

Breach of good faith and fair dealing claims do have significant
limitations. The implied covenant cannot conflict with any of the
provisions of the express agreement.\textsuperscript{153} The implied covenant is also
limited to the original scope of the agreement.\textsuperscript{154} Direct conflict with an
express provision is straightforward, but the exact "scope" of an
agreement can be the subject of significant disagreement.

Various Schwab short-term bond and liquid assets funds
("Schwab Funds") allege that the reference banks breached the implied
covenant of good faith and fair dealing in the various LIBOR-based
contracts held by the Schwab Funds.\textsuperscript{155} The Schwab Funds allege that

\begin{footnotes}
\item[146] Id.
\item[147] Id.
\item[148] Id. at 920-921.
\item[149] Id.
\item[150] Id. at 921.
\item[151] Id.
\item[152] Id.
\item[153] Id.
\item[154] Id.
\item[155] Am. Compl., supra note 23, at 97-98. The Southern District of New York has
since consolidated the Schwab Funds' lawsuit into the larger Berkshire Bank class action.
\end{footnotes}
they have performed all of their obligations under the LIBOR-based contracts, and fulfilled all conditions necessary for the Defendants’ performance.\textsuperscript{156} Schwab Funds’ amended complaint then goes on to allege that the Defendants “secretly” manipulated LIBOR downward, and therefore unfairly interfered with Schwab Funds’ “right to receive the benefits of the subject contracts.”\textsuperscript{157} Schwab Funds’ reduced return on these contracts constitutes the injury in this cause of action.\textsuperscript{158}

Instead of focusing on the “spirit” of the contracts or advocating for any “extrapolated terms,” as required under implied covenant of good faith and fair dealing precedent, the Schwab Funds rely on the complaint’s lengthy discussion of LIBOR manipulation by the Defendants.\textsuperscript{159} The court’s acceptance of the Schwab Funds’ LIBOR manipulation theory will determine whether enough bad faith has been established to warrant a breach of this implied covenant. The Schwab Funds also fail to define or discuss their “right to receive the benefits of the subject contracts.”\textsuperscript{160} Instead of asserting a right, the Schwab Funds could have chosen to keep the court grounded in contract law by using language such as “the benefit of the bargain” or framing the loss in terms of “expectations.” The language of this section does not strictly adhere to tort and contract law elements, but sufficiently alleges the contours of a claim for breach of the implied covenant of good faith and fair dealing. Recovery under this claim will depend upon the court’s acceptance of the Schwab Funds’ discussion of LIBOR manipulation.

D. Unjust Enrichment/Disgorgement Claims

Unjust enrichment is a claim in equity available against parties who have received and retained ill-begotten gains. Unjust enrichment is usually only available in the absence of an explicit contract between the parties, but is available in some jurisdictions when the contract is fraudulent. The plaintiffs in the Berkshire Bank suit claim that it would


\textsuperscript{156} Ame. Compl., \textit{supra} note 23, at 98.

\textsuperscript{157} Id.

\textsuperscript{158} Id.

\textsuperscript{159} \textit{See id.} at 98 (citing to the manipulation “as alleged in the foregoing paragraphs of this Complaint”).

\textsuperscript{160} Id. at 98.
be inequitable to allow the banks to retain profits gained from their manipulation of LIBOR. The plaintiffs request that the court place the Defendants' unjust gains in a constructive trust for the benefit of the plaintiff class and/or require the Defendants to pay out restitution to each individual plaintiff.

The problem with this cause of action is the measure of damages. It faces all the uncertainty of calculating the "accurate" LIBOR, but also has the added insecurity of equitable relief. A constructive trust or a calculation of damages for each individual plaintiff both require a substantial amount of judicial action.

E. Mutual Mistake Claims

LIBOR plaintiffs could also pursue mutual mistake claims. The elements of a mutual mistake are: (1) the parties to a contract were mistaken in their belief regarding a fact; (2) the mistake constitutes a basic assumption underlying the contract; (3) the mistake had a material effect on the bargain; and (4) the contract did not put the risk of the mistake on the party alleging mistake.

In very limited circumstances, a party can allege a bona fide mutual mistake in the contract. A party can only win a mistake claim if the mistake is a mistake of fact, not a mistake in judgment. Mistakes in judgment are inherent risks in the bargaining process, and the court will not award relief for such a fundamental contractual risks. A party does not have a mistake claim solely because the parties were mistaken "in their prediction of a certain event, or that conditions would change." The mistake cannot be as to a future event, and the mistake must relate to a basic assumption as to a vital existing fact.

162. Id. at 14.
164. JOHN D. CALAMARI & JOSEPH M. PERILLO, CONTRACTS 362 (West, 5th ed. 2009) [hereinafter CALAMARI & PERILLO].
165. Id.
166. Id.
168. Id.; CALAMARI & PERILLO, supra note 164.
Despite these limitations, mutual mistake may hold promise for LIBOR plaintiffs. None of the LIBOR plaintiffs have alleged a claim of mutual mistake, despite this claim’s fit with the circumstances. Moreover, mutual mistake is a logical ancillary to fraud claims. Defendant reference banks can argue good faith as a defense to fraud claims. If good faith on the part of the reference bank is accepted, this leads to the conclusion that both parties erroneously believed in LIBOR’s impartiality, thereby establishing a mutual mistake claim. In the absence of bad faith on the part of the banks, the parties were simply mistaken in their belief regarding the material fact of LIBOR’s status as an independent benchmark. Because it is a mistake concerning the factual nature of LIBOR’s integrity, this constitutes a mistake of fact, and not a mistake in judgment. Underlying any financial agreement that used the rate is the basic assumption that LIBOR is an accurate, independent rate. LIBOR’s independence and accuracy are vital to the contracts, so any alteration or inaccuracy in LIBOR has material effects on the bargain. Any defendant would be hard pressed to argue that the contract put the risk of the mistake on the plaintiff. Plaintiffs who have gone to the lengths of establishing fraud or antitrust claims can assert mutual mistake claims as valid fall-back claims. A mutual mistake claim is a solid additional claim that would enable plaintiffs to recover even if the court finds no conscious manipulation on the part of the banks.

F. Frustration of Purpose Claims

Another potential claim available to LIBOR plaintiffs is frustration of purpose. According to the Restatement (Second) of Contracts, where “a party’s principal purpose is substantially frustrated without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his remaining duties to render performance are discharged, unless the language or the circumstances indicate the contrary.” The party must prove the “purpose” of the contract, the substantiality of the frustration, and that the non-occurrence of the frustrating event was a basic

assumption of the contract. Applying these elements to LIBOR-related contracts reveals that frustration of purpose is a viable claim for LIBOR plaintiffs seeking to void contracts on which they have lost money.

The core purpose of many of the LIBOR-related contracts was to lock in a predictable interest rate by pairing LIBOR with a fixed rate. The "purpose" that was frustrated must have been the core purpose the party had in mind when making the contract. The frustrated purpose cannot be "some specific object" the party had in mind, but rather "completely the basis of the contract." LIBOR plaintiffs' desire for a predictable, stable interest rate drove many of these transactions and could rightly be considered "completely the basis of the contract." The purpose must be so central to the contract that the transaction simply would not make sense without it. Some of the LIBOR-related contracts discussed earlier would not make sense without the purpose of locking in a fixed interest rate.

Another requirement is that the frustration must have been "substantial." Substantial frustration requires more than a showing that the party will incur unforeseen losses. The frustration must be outside of the assumed risks of the contract and unfairly severe. The manipulation of LIBOR caused some of the LIBOR plaintiffs to incur exactly the unforeseen losses which they allege as the harm in their existing complaints. LIBOR's complete departure from its historical relationship with the other market rates constitutes an unfairly severe frustration outside of the assumed risks of the various financial contracts that use the rate. The typical allegations of injury and harm that plaintiffs allege in connection with other causes of action satisfy the element of substantial frustration.

Finally, "the non-occurrence of the frustrating event must have

170. Id. cmt. a.
171. Interview with Alexander Arapoglou, supra note 78.
172. Id.
173. Id.
174. Id.
175. Id.
176. Id.
177. Id.
178. Id.
been a basic assumption on which the contract was made." Similar to the first element of frustration, the assumption must have been extremely central to the contract, a fundamental concept implicit in the bargain. The assumption that LIBOR would not crumble entirely stood at the heart of LIBOR-related contracts. The parties held a basic assumption that LIBOR would continue in its capacity as a crucial benchmark rate. Foreseeability plays a significant role in this determination, but the fact that the event was somewhat foreseeable does not doom the claim. The parties did not foresee the LIBOR scandal, the event which frustrated the purpose of these contracts, assuming it would continue to maintain its traditional centrality.

Similarly to mutual mistake, the LIBOR plaintiffs have not alleged any frustration of purpose claims. This is perhaps because the remedy for frustration of purpose is discharge of the remaining duties under the contract. Frustration of purpose will only aid LIBOR plaintiffs who have outstanding payments due under LIBOR-related contracts, making it a particularly attractive claim for municipalities who face high refinance costs. This claim will, however, allow current or future LIBOR plaintiffs to sustain pleading burdens and avoid further payments.

V. BARRIERS TO RECOVERY

The composite nature of LIBOR poses significant problems for all plaintiffs seeking to recover on LIBOR-related contracts. The effect of one bank’s quotes over a given period of time on the overall LIBOR will be hard to prove. Complex analyses, like the ones conducted by the Wall Street Journal and Professors Snyder and Youle, are needed in order to overcome these difficulties and prove injury in fact. In defense of these claims, each individual reference bank can validly argue that its quote did not have a significant effect on the overall

179. Id.
180. Id.
181. Id.
LIBOR.¹⁸⁴

Plaintiffs must first prove how many overall percentage points the manipulation achieved.¹⁸⁵ However, concrete interbank data for actual loans is almost nonexistent because of the dearth of interbank loans during the financial crisis. Consequently, this determination will necessarily hinge on a comparison to other market benchmarks, like CDS spreads and Eurodollar bid rates.¹⁸⁶ Plaintiffs will also have a difficult time quantifying their damages.¹⁸⁷ Litigants will spend lots of time (and money) arguing over the correct method for determining the alteration percentage.

To date, the consolidated class of plaintiffs in the Southern District of New York has not alleged a specific amount of damages due to the class. They assert, however, that these barriers to recovery can be easily overcome “via discovery and expert testimony.”¹⁸⁸ The plaintiffs allege that calculation of damages will be straightforward, accomplished by “the simple process of comparing the interests [plaintiffs] should have received with what they were actually paid due to the suppressed LIBOR.”¹⁸⁹

If a manipulation percentage can be proven to a satisfactory level of definiteness, litigants can calculate their actual damages based on overall exposure to LIBOR.¹⁹⁰ For example, if the court determines that LIBOR was artificially lowered by .3%, an investor holding “interest rate swaps on bonds worth $1 billion” will allege damages of $3 million a year.¹⁹¹ In New York, the Nassau County Comptroller, George Maragos, has calculated that his county lost $13 million on outstanding bonds because of LIBOR manipulation.¹⁹² Assuming .3% as the average level of “skewing,”¹⁹³ a very reasonable percentage based

¹⁸⁴. Id.
¹⁸⁵. Popper, supra note 81.
¹⁸⁷. Touryalai, supra note 183.
¹⁸⁹. Id.
¹⁹⁰. Popper, supra note 81.
¹⁹¹. Id.
¹⁹². Id.
¹⁹³. The “skew” is the change in LIBOR’s historical relationship with other market data. LIBOR typically had a relationship with lending rates in the Eurodollar market and the Eurodollar rate. Snider and Youle calculate the magnitude of skewing by analyzing
on the calculations of Snider and Youle, and applying it to the $1.3 billion in swap exposure posited by N.C. Treasurer Janet Cowell, North Carolina could claim damages of $3.9 million per year on its swap contracts alone.\textsuperscript{194}

VI. CONCLUSION

The Barclays fine of June 2012 started what promises to be a massive flood of litigation focused on the LIBOR scandal. The recent UBS settlement perhaps provided more in the way of specific findings and elements of evidence for LIBOR plaintiffs than the Barclays settlement. The CFTC's UBS report contains four pages of "Examples of Misconduct From Written Communications," which includes emails and text messages.\textsuperscript{195} This evidence proves knowledge of senior management and will fuel the fires of private litigation.\textsuperscript{196} Regulatory findings like these will continue to drive litigation, whether or not they are as massive and widespread as the ones which led to the UBS and Barclays settlements. Fear of similar findings coming to light during the discovery process will bring reference banks to the settlement table.

Despite the advantages given to LIBOR plaintiffs by these regulatory investigations, there are still significant barriers to recovery. Disagreements over how to calculate a manipulation percentage from which to compute damages will prolong litigation. The Mollenkamp and Whitehouse study keyed its alternative rate to default-insurance rates, but, as recognized by Snider and Youle, this is but one method for determining an "accurate" LIBOR.\textsuperscript{197} The need for expert financial testimony and extensive discovery will drive up the cost of litigation. Ultimately, these barriers will bring LIBOR plaintiffs to the settlement table.

\begin{flushleft}
\textsuperscript{194} Snider & Youle, supra note 31, at 3.
\textsuperscript{195} Id. at 9.
\textsuperscript{196} Id.
\textsuperscript{197} Id.
\end{flushleft}
Lawsuits of similar scale have shown that the settlement option is the most attractive option for reference banks. Unless one reference bank can sufficiently distance itself from the others and can claim no wrongdoing, it appears to be in the best interest of each member bank to settle these claims. The reference banks would then switch to a strategy to give any settlement the force of res judicata in order to stem the tide of litigation.

The settlement option will also be preferred by government officials. Concerns over the survival of UBS and its importance to the financial stability of the global economy led the U.S. Department of Justice to announce it will not pursue any legal action against the bank. Many of the LIBOR plaintiffs are the same attorneys general and regulatory agencies that negotiated settlements in the wake of the mortgage crisis. Similar concerns will drive some of the institutional LIBOR plaintiffs to consider settlement proposals. Although some LIBOR lawsuits may be litigated to a verdict, it is more likely that these complex and pervasive claims will be settled, either through private or government action.

C. COWDEN W. RAYBURN

198. The settlements in the wake of the mortgage crisis, Exxon Valdez spill, and the Deepwater Horizon Oil Spill are similar scandals with massive classes. See, e.g., Order and Judgment Granting Final Approval of Economic and Property Damages Settlement and Confirming Certification of the Economic and Property Damages Settlement Class, In Re: Oil Spill by the Oil Rig “Deepwater Horizon” in the Gulf of Mexico, on April 20, 2010 (Dec. 21, 2012) (MDL No. 2179) (establishing a fund for class members).

199. Enrich & Eaglesham, supra note 1.

200. See generally Joint State-Federal Mortgage Servicing Settlement FAQ, NATIONAL MORTGAGE SETTLEMENT, http://nationalmortgagesettlement.com/faq (site maintained by the Attorneys General on the Executive Committee that negotiated the settlement detailing the application process for class members).