

Financial Crisis and its Impact on International Litigation

It does not require any clairvoyance to foretell the torrent of litigation during a financial crisis. The impact of a financial crisis on the economy is far-reaching since liquidity would slowly commence depleting, termination of jobs would become rampant and satisfying financial commitments would become intricate. The parties to any given transaction may compete in abdicating their obligations out of constraints and the consequences would be tumultuous.

Even the layman is aware, the subprime mortgage crisis in the United States of America has contributed the current financial crisis ("Crisis"). Predictably, the Crisis has capsized the banking and financial industry and is generating a boon for the lawyers. The Crisis is likely to bring about a catena of sweeping changes in the legal realm. The topic is seamless and the ramifications are all-encompassing. A brief analysis of some of the said issues is attempted herein.

Litigation in Financial Sector

The subprime mortgage crisis has created ripples in the financial sector, especially in the banking and securities industry, and has led to a flurry of litigation. There has been significant litigation involving statutory authorities against lenders, appraisers, brokers and other intermediaries, in addition to the litigation among themselves.

In the US, litigation continues to be commenced against many financial market participants associated with sub-prime mortgages and securities. The causes of action have been varied, and include: shareholders suing sub-prime lenders for their failure to disclose the existence of high default rates on sub-prime loans; the regulatory authorities suing sub-prime lenders for fraud as the latter sought to hide their losses; and investors suing issuers of sub-prime backed securities for breach of contract and their fiduciary duties.

In contrast to the US, relatively few proceedings have been initiated in Australia related to the sub-prime crisis. The litigation has primarily arisen under the following categories: claims against listed companies significantly affected by the liquidity freeze which have suffered considerable declines in their share prices; and claims against participants in the financial market who have some involvement with structured finance products.

In the United Kingdom, apart from the above, the collapse of the market for auction rate securities ("ARS") is also generating a spate of litigation, mostly instituted by ARS investors against the broker dealers. More recently, companies that invested in ARS and carried the securities on their balance sheet have been sued by their own shareholders in connection with the companies' ARS disclosures.

Another major chunk of the litigation that may arise out of the Crisis would pertain to issues related to insurance. Claim activities generally find an increasing trend on any economic downturn, and this time too, it is presumed that many companies may make claims for losses arising out of the Crisis. It is anticipated that the investors may attempt to make good their securities-fraud losses by tapping into the various coverages of the firms they hold accountable for their economic ruin, like claims on errors & omissions (E&O Claims) and directors & officers' negligence (D&O Claims) etc.

The investors may claim against their brokers for not predicting the downturn, or for moving funds into something too risky that was subject to the downturn. Subsequently, litigations against companies and their executives for alleged conduct that resulted in losses would continue to pile up.

Rating agencies have also been the target of substantial criticism for their alleged failure to properly rate mortgage backed securities and collateralized debt obligations backed by subprime mortgages, and their delay in downgrading the bonds as default and foreclosure rates rose. Investors may contend that they would not have bought the bonds if the agencies had properly rated them, or that they would have sold them immediately if they had known the true value of the bonds.

Litigation against Professionals

It is highly probable that the accountability of professionals from varied disciplines may be challenged during the Crisis, mainly those who have involved in the lending or securitization processes, such as auditors, mortgage brokers, lawyers, investment advisors, investment fund managers etc.

Though not many seem to be concerned about the extent of bad loans accrued by major financial institutions, or over the risks the banks exposed themselves to by entering into derivative contracts, the general opinion is that auditors have played a major role in the ensuing debacle.

Their opinion that promoted what turned out to be failed investment opportunities may well lead to negligence actions by the investors. In the case of either insolvency or discovery of fraud, the insurance-backed professional advisers may often be the only prospect of compensation and therefore may attract claims.

Nevertheless, the probability of success of any legal action against auditors would depend upon the territorial jurisdictions from where the firms operate. In certain countries like the US, it appears that the auditors owe a duty of care to investors, whereas, in the UK, the auditors do not owe any such duty to individual shareholders.

Bankruptcy Litigation

The Crisis has compelled myriad companies and individuals to apply for bankruptcy as they are squeezed by a combination of substantial financial burden and lack of cheap credit. Many of them are slowly realizing that they do not have enough credit to honor their financial commitments, and as a result they are left with no other alternatives but to file for bankruptcy. The impact of the situation where the creditors understand that the debtor is facing bankruptcy and are apprehensive of retrieving the amounts, could really be dramatic. This may put the entire system under huge pressure. Further, the lack of sophisticated bankruptcy laws and the inability of individuals to file for bankruptcy are certain to spring up serious concerns at least in some jurisdictions, for instance, the UAE.

Litigation Related to Intellectual Property Rights

A glimpse at the history hints that the intellectual property rights (“IPR”) market has always registered momentous growth during economic downturns. It is a time where the companies

would aim to increase their cash flow by product innovation and litigation. They strive to create indispensable products for the consumers and attempt to protect their innovations. Consequently, the Crisis may witness an increased traffic in IPR litigations.

The creative industry has always been subjected to copycat works and plagiarism, and the problem is very familiar to film and music industry. The internet has made piracy virtually impossible to control owing to the vast and unregulated nature of the web, and this causes substantial loss to the industry. Nonetheless, the big players in the industry are increasingly challenging the violations these days, desperate to reduce the losses.

Most of the countries have signed the Berne Convention for the Protection of Literary & Artistic Works, the Agreement on Trade Related Aspects of Intellectual Property Rights, and have enacted legislations to protect creativity. However, the difference in the intensity of penal provisions and lack of effective mechanisms to tackle the issue desists from warranting uniform protection across the world.

Litigation on Real Estate Sector

The Crisis has hit the real estate sector directly and terribly, and the quintessence in this regard is Dubai. Dubai has been one among the most flourishing economies of the Middle East till recent times, primarily due to the real estate boom. Rocketing economy, relaxed procedures and surging rents instigated many a people to invest in this sector.

However, the crisis has hampered the growth, if not, devastated the sector at least temporarily. Souring rents and prices have made most of the investors frantic, and are desperately requesting the developers to terminate their contracts. The developers too are concerned as it affects their liquidity, in turn resulting in delayed handing over, alteration of designs, increase of prices etc. leading to disputes.

Despite being of recent origin, the boom was offering immense profits for everyone involved in the sector, and hence, the region never experienced any problems of this nature earlier. A state of smugness embraced them and many of the parties did not even seek any legal opinion before executing their contracts. Now, many realize that the allocation of risks as between them is not quite as fancied.

Many of the financial institutions, developers and investors are renegotiating contracts, and litigations are escalating day by day. The dearth of comprehensive laws, want of proper documentation, lack of sophisticated bankruptcy laws and the fact that developments were financed by selling units off-plan complicate the disputes.

Amid the prevailing uncertainties, commercial counterparties are desperately considering if and how they can safeguard their interests by litigation. The courts may find many new contentious issues coming before its consideration. It is also significant that many of the documentation based upon which the disputes are raised have never been tested before the courts. The circumstances in which it is now required to respond were never contemplated at the time of their execution. The scope and nature of litigious issues is swiftly developing and constantly changing, and this would continue to be so at least in the recent future.

Litigation on Labor Matters

The Crisis is a phenomenon that was starkly unheard of in the recent past, and labor legislations of many of the countries are not equipped to deal with a scenario that witness mass termination of jobs. The crisis has obligated many companies to consider mass lay off plans, performance based terminations, reduction of wages, and requiring employees to take leave without wages.

Unlike in sound economic conditions, the employees are not provided with attractive severance options and they are marginally successful in mitigating losses with a new job. The Crisis would leave the redundant employees in a desperate scenario and the propriety of many such issues would be tested before the courts. The redundancy may lead to a situation where many would find it difficult to pay off their loans, finally paving way for endless litigations. It is learnt that in some countries like China, labor litigations have nearly doubled last year, a direct outcome of the Crisis.

Litigation on Inheritance

Albeit not of great significance, it is worth mentioning that litigation related to inheritance could rise considerably during the Crisis. The declining real estate prices and mounting interest rates may have a drastic impact, and consequently, scores of thousands of wills and testaments written by various testators may not be as worthy as at the time of their execution. The uneven change of worth of diverse form of assets may tend to affect the financial security of many of the legatees, though many people are yet to realize the brunt the Crisis may have on the provisions they have arranged for their beloveds.

Interpretation of Contracts

As anyone who is savvy with the legal drafting would admit, contracts may often contain certain provisions that are intentionally left ambiguous. It is difficult to accurately specify the situations wherein they may come in to application since it could lead to complications during drafting itself or negotiation. The paradigm of such a provision is the clause on “material adverse change” – which excuses the performance of a contract by one party on the occurrence of a contingency that adversely affects the condition of the other. Normally, such clauses would not specifically stipulate the changes that might justify the termination of a contract.

The logic behind the insertion of such ambiguous clauses is that, in most of the circumstances, issues pertaining to their application may never arise. Thus, incorporation of such clauses allows parties to bypass difficult negotiations that could disrupt an otherwise fine transaction. However, pursuant to the Crisis, many may rely on such clauses to evade performance of their obligations under the contracts. When issues do arise on such ambiguous clauses, it is almost certain that the parties may choose to litigate leaving a chance.

Attitude of Courts

The Crisis is slowly gripping the functioning of every element of the legal system across the world. The judiciary is no exception to this, though the attitude of the courts surface diversely in various jurisdictions.

In a recent instance, a French court has dismissed the plea of a US corporate giant to lay off about 700 of its employees, requiring the company's management to negotiate a plan that would

save the jobs. It is learnt that the same suit is followed by many other courts across the world, particularly on issues related to labor. The decisions in this regard are a welcome trend and are to be acclaimed on humanitarian grounds, since it may provide some respite to innumerable persons hit by the Crisis.

However, the labor legislations of many countries are not comprehensive enough to protect the interests of the working class. Many of them permit the employers to terminate the services of an employee by paying meager compensation under certain circumstances, thereby challenging the very objectives of the enactment. If such terminations could be effected under the guise of the Crisis is a very relevant and debatable question, and it appears that the courts are complacent following the defined path, the history of which has never seen an economic downturn.

It must be remembered that no economy can ensure a sustained growth and no nation can boast of being a welfare state unless and until it protects the interests of every individual of the society. The judiciary has a got a decisive role to play in safeguarding the rights of the people from all sorts of interventions, and it must reflect in each of its decisions.

Re-appraisal of Transactions

The Crisis has obliged myriad companies to unveil the transactions they have entered into in the yester years and meticulously analyze the practicability of their executions. The financial aspects involved in such transactions could force many of them to think about terminating the said transactions, providing innovative interpretation to the contracts or inventing grounds for new claims, eventually leading to more litigation.

Many companies now understand that they do not have enough credit to honor their financial commitments, and this may pave way for a dramatic increase in commercial litigation, mainly pertaining to breach of contracts.

Exploring Alternate Dispute Resolution Mechanisms

The uncertainties of the prevailing economic environment and strained budgets are constraining many companies to introduce effective cost-control mechanisms in every aspects of their business.

Obviously, the legal department may become one among the prime targets of this decision. Serious thoughts would be undertaken on the cost and risk of contested litigation and managing the expenses of external lawyers. The relative values of success, loss and settlement of disputes; the quality of transaction negotiations and documentation; and the efficiency of external lawyers in safeguarding the interests of the companies would definitely be scrutinized.

The corporations are suddenly realizing the significance of ADR, and its decisiveness in the success and competitiveness of a matured economy. Many are re-evaluating protracted litigation and are exploring new approaches to resolve the differences. None is capable of forejudging the duration of the Crisis, and this facilitates a favorable ambiance for skilled negotiation and amicable settlement. Further, the fact that people are generally more satisfied with an agreed resolution rather than an imposed court decision may also bolster the cause for ADR.

Albeit it is not prudent to envisage now that companies are turning away from litigation, it is increasingly seen that many are attracted to the informal nature, cost-effectiveness and the absence of procedural stringiness of ADR.

Statistics suggest that in many parts of the world, the trend is increasingly on the rise. According to the Institute of Arbitrators and Mediators Australia, mediation nominations have witnessed almost cent per cent increase in 2008 and 2009. Similar trend is discernable in UAE also, and the mounting number of cases before the Dubai International Arbitration Centre, the Abu Dhabi Commercial Conciliation and Arbitration Centre, and the DIFC LCIA Arbitration Centre evidence the phenomenal augmentation of arbitration. The fact that most of the investors are expatriates, who are not much conversant with the local laws and the existence of parallel hierarchy of courts for different emirates, also contribute to the growing arbitration culture.

In Dubai, measures are afoot to institute a new mediation centre to resolve real estate disputes. The Crisis has lead to innumerable disputes between the contracting parties, and the authorities are encouraging parties to amicably settle the disputes, before they resort to the property court. The authorities are clearly aware of the situation that may result from endless litigation, as the economy is heavily reliant on the real estate sector.

Legal Aid for Indigent People

In many jurisdictions, particularly in the US, the Crisis is severely affecting indigent people who require legal aid. Many of the programs that provided free legal aid to the indigent were partly funded through interest on accounts for real estate transactions. Since the real estate market collapsed and the interest rates have slashed, these funds have also vanished. Resultantly, thousands of people across the region may not have the same access to legal protection as they had prior to the Crisis.

As many of the economists who participated in the meeting of the United Nations Development Project recently held in Bangkok has opined, the economic crisis would increase the demand for justice among the poor, especially to protect their property, jobs, working conditions and their right to do business without extortion. It is really disheartening that many of them could not even challenge their termination of jobs or loss of property, for want of sufficient funds.

Conclusion

The Crisis has brought about multitude of quandaries to corporate entities and has created an impasse on the lives of innumerable people across the globe. As discussed, the Crisis may spawn a cascade of litigation, though it is also likely to breed punctilious review of the services provided by the lawyers. Be that as it may, the Crisis could be reckoned as the best opportunity to introspect and take curative measures. The Crisis must oblige everyone in the legal fraternity to embrace a more pro-active stance comprising of innovative strategies, cost-effective services, and creative solutions. Above all, let us not forget to implement every lesson taught by the Crisis with a humane touch.

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