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Is Hedging Market Manipulation? A Review of the Second Circuit's Decision in *Set Capital LLC v. Credit Suisse Group AG*

Investors throughout the world use "hedging" activities to reduce risk in their investment portfolios. But can "open-market" hedging activity constitute market manipulation under the Securities Exchange Act of 1934? According to a recent decision from the Court of Appeals for the Second Circuit, the answer appears to be yes, *if* the hedging activity is specifically intended or designed to manipulate the price of a security.

In April, the Court of Appeals for the Second Circuit revived investors' market manipulation claims against Credit Suisse Group AG ("Credit Suisse") arising from its open-market hedging activities. *Set Capital LLC v. Credit Suisse Group AG*, 996 F.3d 64 (2d Cir. 2021). Specifically, the Second Circuit issued an order vacating and remanding, in significant part, the Southern District of New York's dismissal of a securities class action alleging that Credit Suisse, among other things, manipulated the market for certain exchange-traded notes.

The plaintiffs in *Set Capital* alleged that Credit Suisse engaged in a scheme to manipulate the market for the VelocityShares Daily Inverse VIX Short-Term ETN ("XIV Notes"), which were exchange traded notes issued by Credit Suisse. The XIV Notes were designed to track the inverse of the S&P 500 VIX Short-Term Futures Index, which was designed to track the VIX Index. The VIX Index, commonly referred to as Wall Street's "fear index," is designed to measure the amount of expected volatility in the market. The VIX Index increases as the market expects higher volatility and decreases as the market expects less volatility.

Because the XIV Notes were designed to track the inverse of the VIX Futures Index, investors in XIV Notes would profit from low volatility in the market

(continued on page 2)

INSIDE

Collective Action Specialist Ravi Nayer Joins London Office

Ravi Nayer has joined the London office as partner. Ravi is a collective action specialist, representing some of the UK's biggest institutions including pension funds, asset managers, and insurers. In addition to advising on the conduct and merits of regulatory enforcement and securities class actions, Nayer advises clients on procedures and governance policies relating to bondholder disputes and related fiduciary duties. Nayer has designed joint defense, compensations schemes, and novel litigation cooperation agreements for corporations in some of the UK's biggest class actions, including the high profile £4 Billion RBS Rights Issue litigation. He was seconded to a major UK FTSE 100 asset manager as its global head of disputes and has experience across multiple jurisdictions including the US, India, North Africa, and the Caribbean. Q

Seventy-One Attorneys Honored as "The Best Lawyers in America"

A staggering seventy-one firm attorneys across nine jurisdictions have been recognized in the 2022 edition of "The Best Lawyers in America." The guide, published by *Best Lawyers* since 1983, serves to highlight the top legal talent in the United States. Q

and would experience losses from high volatility. To hedge the volatility risk associated with the XIV Notes, Credit Suisse bought the underlying VIX futures contracts. However, purchasing VIX futures contracts, even as a legitimate hedge, could drive up the value of the VIX Futures Index, thereby driving down the value of XIV Notes.

The complaint alleges that after observing prior episodes of market volatility in 2011, 2015, and 2016, Credit Suisse determined how to depress prices for XIV Notes by purchasing VIX futures contracts on days when volatility spiked, to hedge against the decline in the price of XIV Notes when volatility increased. Each time volatility spiked, Credit Suisse's hedging contributed to a liquidity squeeze in VIX futures contracts that depressed the value of XIV Notes. In the offering documents for the XIV Notes, Credit Suisse stated that it "had no reason to believe" that any impact of its hedging activity would be "material."

According to plaintiffs, Credit Suisse—with knowledge of how to manipulate the price of the VIX Futures Index—engaged in a scheme to sell millions of XIV Notes before engineering a significant collapse in their price through Credit Suisse's own open market "hedging activity." By offering 5,000,000 XIV Notes on June 30, 2017 and another 16,275,000 Notes on January 29, 2018, the complaint alleges that Credit Suisse both created the need to hedge and created conditions in which it knew that its hedging trades would destroy the value of XIV Notes during the next volatility spike. When a spike occurred one week later on February 5, 2018, Credit Suisse purchased more than 105,000 VIX futures contracts, which caused the price of XIV Notes to crash by more than 96%. Credit Suisse declared an Acceleration Event to redeem the XIV Notes at the depressed price, resulting in significant profit to Credit Suisse and substantial losses to investors.

The plaintiffs brought claims for, among other things, violations of Section 10(b)-5(a) and (c) of the Exchange Act and Rule 10b-5 for defendants' alleged scheme to manipulate the market for XIV Notes. Defendants moved to dismiss the complaint in its entirety, arguing that the plaintiffs failed to allege a "manipulative event" under Section 10(b)-5(a) and (c), and failed to plead a strong inference of scienter as required by Section 10(b). They argued further that Credit Suisse's hedging trades were "done openly" in order to "manage risk" and not to deceive investors.

In September 2019, U.S. District Judge Analisa Torres agreed with the defendants and dismissed the plaintiffs' claims, holding that the plaintiffs did not plead facts supporting a strong inference of scienter, and that Credit Suisse had simply taken advantage of market conditions, engaged in typical hedging activities, and was not trying to defraud investors. The plaintiffs appealed.

In a noteworthy victory for the plaintiffs, the Second Circuit reversed, in significant part, finding that the plaintiffs did adequately allege both a manipulative act and a strong inference of scienter in support of their market manipulation claim, thereby permitting market manipulation claims against an issuer arising from its open-market hedging activities.

The Second Circuit explained that a "manipulative act" is one that is "intended to mislead investors by artificially affecting market activity," and requires a determination "whether the transaction or series of transactions sends a false pricing signal to the market or otherwise distorts estimates of the underlying economic value of the securities traded." Applying that standard, the Court determined that Credit Suisse's actions constituted market manipulation because they were designed to cause the price of the XIV Notes to plummet.

Perhaps most notably, the Court rejected Defendants' argument that Credit Suisse's hedging activities could not be actionable under the federal securities laws since they were done openly and therefore could not have caused an "artificial" impact on the price of XIV Notes. Although the Court acknowledged that "it is generally true that short selling or other hedging activity is not, by itself, manipulative—even when it occurs in high volumes and even when it impacts the market price for a security," it ruled that "the complaint alleges more than routine hedging activity." Specifically, the Second Circuit pointed to the plaintiff's allegation that Credit Suisse's decision to flood the market with millions of additional XIV Notes was done for the precise purpose of enabling its hedging activity to collapse the price of the XIV Notes. Thus, the Court reasoned that "it is no defense that Credit Suisse's transactions were visible to the market and reflected otherwise legal activity" because such transactions can still "constitute manipulative activity when accompanied by manipulative intent," as was alleged in the complaint. Indeed, the Court observed that "[i]n some cases, as here, 'scienter is the only factor that distinguishes legitimate trading from improper manipulation.'"

With respect to scienter, the Second Circuit ruled that the allegations of scienter were at least as compelling as any competing inferences, holding that the plaintiffs alleged "circumstantial evidence of conscious misbehavior or recklessness that, when viewed holistically and together with the allegations of motive and opportunity, supports a strong inference

of scienter." In reaching this conclusion, the Court noted that (1) the defendants had the opportunity to observe volatility spikes on three prior occasions (2011, 2015, and 2016) and the impact of their hedging trades in futures contracts during those spikes, combined with the defendants' responsive actions following those spikes, supported a strong inference of scienter; (2) the defendants knowingly or recklessly exacerbated the liquidity squeeze they observed in the VIX futures market by increasing the number of XIV Notes outstanding despite its knowledge that it would then have to make additional hedges that would have a significant impact on the value of the XIV Notes it just issued; and (3) the plaintiffs set forth additional allegations and circumstantial evidence that bolstered an inference of manipulative intent.

The Second Circuit's articulation of market manipulation in *Set Capital* appears to bring market manipulation under the Exchange Act more in line with market manipulation under the Commodities Exchange Act and the Energy Policy Act, which grant the Commodity Futures Trading Commission ("CFTC") and Federal Energy Regulatory Commission ("FERC") authority to pursue market manipulation claims within their respective jurisdictions.

For example, in *In re Amaranth Natural Gas Commodities Litigation*, the court sustained a market manipulation claim under the Commodities Exchange Act, reasoning that an otherwise "legitimate transaction"—there, the buying and holding of large energy contracts—could "constitute manipulation" if combined with "wrongful intent." 587 F. Supp. 2d 513, 535 (S.D.N.Y. 2008), *aff'd,* 730 F.3d 170 (2d Cir. 2013). Similarly, in *In re ETRACOM LLC*, FERC recognized that it "has consistently found to be manipulative 'cross-market' schemes in which market participants improperly trade in one market with the intent to move prices in a particular direction to the benefit of positions in a related market." 2016 WL 3405304 (F.E.R.C. Jun. 17, 2016), at *22. Thus, the Second Circuit appears to be extending the rationale of "open market" market manipulation under the Commodities Exchange Act and Energy Policy Act to the Securities Exchange Act.

This extension was previously advocated for by Solus Alternative Asset Management LP—represented by Quinn Emanuel—in its high-profile action against, among others, GSO Capital Partners and Hovnanian Enterprises, Inc., for market manipulation under the Securities Exchange Act. There, Solus alleged that GSO offered Hovnanian below-market cost financing in exchange for Hovnanian's agreement to default on a small portion of Hovnanian's debt in order to benefit GSO's positions in credit default swaps referencing Hovnanian. In response, GSO argued, like the Defendants in *Set Capital*, that the alleged manipulation—providing below-market financing in order to benefit GSO's position in the credit default swap market—could not constitute market manipulation because, even if intended to impact the credit default swap market, it was an "open market" transaction. Solus argued—relying on, among other authorities, market manipulation cases under the Commodities Exchange Act and the Energy Policy Act—that an "open market" transaction done with the intent to impact the price of a security can constitute market manipulation. Solus' case was resolved before the Court issued a decision on GSO's motion to dismiss. However, Solus' (at the time) novel argument is consistent with the position adopted by the Second Circuit in *Set Capital*.

Although it remains to be seen what impact the Second Circuit's decision will have on market manipulation cases going forward, it may have significant implications for certain trading practices that are becoming more common. For example, the decision may have implications for recent trading activity in "meme stocks," such as GameStop, where groups of investors engaged in trading for the stated purpose of causing a "short squeeze" that was intended to inflate the price of the stock. In light of the Second Circuit's decision, such "open market" activity could arguably be deemed "manipulative" if the Court determines that the trades were made with the "manipulative intent" of impacting the stock price.

DeFi and Potential Lender Liability

What Is DeFi?

DeFi is short for "decentralized finance." It refers to financial services for cryptocurrencies that are built on top of distributed blockchain networks with no central intermediaries. Because cryptocurrencies are decentralized in nature, the financial services for cryptocurrencies are also called "decentralized finance" or "DeFi" to reflect the same decentralized concept. Data shows that tens of billions of U.S. dollars' worth of cryptocurrencies are being used in DeFi transactions every week. DeFi spans numerous subsectors, including lending, exchanges, derivatives, and payments. This article focuses on the lending sector.

While DeFi is new and ever-changing, lending is one of the largest and most mature DeFi sectors. Most DeFi lending is backed by borrowers' assets. Thus, the DeFi lending market size can be measured by the value of assets deposited into DeFi platforms by both the lenders (the cryptocurrency to be borrowed) and the borrowers (the cryptocurrency acting as security), which is sometimes called Total Value Locked (or "TVL"). Recent reporting puts TVL in the DeFi lending market at several tens of billions of dollars. Significant players in the DeFi lending sector include Aave, Maker, Compound, InstaDApp, and Liquity, each of which reportedly has over one billion TVL in lending on its platform.

Leverage – the use of borrowed funds to make investments – is popular in DeFi because of cryptocurrencies' price volatility. For example, assume one has Crypto A and believes the value will increase, but she also wants to buy Crypto B because she believes Crypto B's value will also increase. Instead of selling Crypto A to buy Crypto B, she could borrow the funds with her Crypto A as collateral and then buy Crypto B with the borrowed funds. This leverage is similar to trading on margin, which offers greater profit potential than traditional trading but also amplifies the effects of losses. The combination of price volatility and leverage practice creates risks in the DeFi lending market.

The Difference Between DeFi and Traditional Finance – Smart Contract

Leveraged trades and collateral assets are not new. What makes DeFi different from traditional financial services is the use of "smart contracts" to facilitate transactions. Cryptocurrency is computer code carried on decentralized computer networks (blockchain networks). Thus, people can embed that code to provide instructions to the blockchain network. For example, the embedded code can automatically transfer cryptocurrency subject to a condition precedent. This type of self-executing contract with the terms of the conditions directly written into lines of code is called a "smart contract." The contractual code exists across a distributed and decentralized blockchain network. The code, not humans, controls the contract execution, and transactions are automatic, which minimizes the risk of arbitrary intervention and manipulation. Thus, the contract is "smart." Smart contracts are the backbone of DeFi systems.

However, due to their technical nature, smart contracts may cause unintended consequences. For example, during high volatility periods, smart contracts may liquidate collateral assets in a way unexpected by borrowers due to their lack of understanding of the technical liquidation conditions. In addition, if the smart contract code has bugs, it may execute or fail to execute transactions inadvertently. If borrowers believe the smart contracts harm their interest, they may pursue lender liability actions.

Who Are the Lenders?

The threshold question for a lender liability lawsuit is—who is the lender? In traditional lending transactions, this is an easy question because "[t]he material terms of a loan include the identity of the lender and borrower." *Peterson Development Co. v. Torrey Pines Bank* (1991) 233 Cal. App. 3d 103, 115. However, in DeFi transactions, the borrowing process could omit the lender's information because the funds may be drawn from decentralized sources. Lenders deposit digital assets into pools, from which assets are drawn for loans obtained through the DeFi platform. Specific lenders are not identified for the borrowers, who received borrowed cryptocurrency in their digital wallets.

Borrowers might argue that the lending platforms are the lenders because the loans are obtained on the platforms, and the lending platforms usually program the smart lending contracts. However, the platforms could argue that the ultimate sources of the funds are decentralized cryptocurrency owners, and the platforms merely bridge the supply and the demand when both accept the lending terms. And many platforms include disclaimers on their "Term of Use" pages stating that they are not parties to the smart contracts and have no control over any transactions. The effect of such disclaimers remains to be examined by courts. Indeed, while the term "decentralized finance" may create an impression that there is no centralized lender in DeFi lending, the lender's identity could be a highly fact-intensive issue.

What Are the Lending Terms?

The lending process is relatively simple compared to a traditional loan application. Borrowers do not need to fill in any loan application forms. The lending platform websites may merely show some critical numbers, such as the interest rate and liquidation penalties, without detailed explanations. A borrower could finish the transaction by clicking a few buttons without seeing the explanations of those critical numbers. For example, the lending platform may show a "10% liquidation penalty" when a borrower fails to meet a margin call. However, there may be no explanation of what a "10% liquidation penalty" means in the lending process. Does it mean 10% of the borrowed assets or 10% of the collateral assets? As of what time are the assets valued? Which exchange platform's price governs the assets' value? To figure out the answers, a borrower may need to read the technical whitepapers of the lending platform or even read the source code of the smart contracts, and the platform may put the borrower on notice of such need. If the borrower fails to reference those materials, there might be a gap between the borrowers' understanding of the lending agreement and the actual lending agreement programmed in the smart contract code.

During contract interpretation, "[t]he whole of a contract is to be taken together, so as to give effect to every part, if reasonably practicable, each clause helping to interpret the other." Cal. Civil Code § 1641. One could argue that the whitepapers and the source code are part of the lending contract or should be considered in contract interpretation. Thus, parties may need to review the source code carefully to support their legal positions in a dispute.

What Lender Liabilities Are at Issue?

Common lender liability claims include breach of contract and fraud. DeFi borrowers may rely on one or more of them in a dispute. For example, when a borrower believes certain code in the smart contract is material but is not disclosed during the lending process, she might argue it is a fraud because the lender fraudulently induced her to enter a lending contract. When liquidation is triggered, DeFi borrowers might argue that the lender inappropriately sold the collateral assets. Courts have relied on the Uniform Commercial Code and held that the method, manner, time, place, and terms of the collateral sale must be "commercially reasonable." *See, e.g., Caterpillar Fin. Servs. Corp. v. Wells*, 278 N.J. Super. 481, 651 A.2d 507 (Law Div. 1994). But whether the Uniform Commercial Code applies to Defi transactions and what is commercially reasonable in the context of DeFi transactions are currently uncharted waters. The coming years will likely see a growth of high-stakes DeFi disputes involving unique and novel legal issues, especially when crypto markets swing in ways that lead to significant losses for DeFi lending participants.

PRACTICE AREA NOTES

Antitrust & Competition Update

Unanimous Decision by the U.S. Supreme Court Recently Halts Federal Trade Commission's Ability To Seek Monetary Relief Under § 13(b) of Federal Trade Commission Act

A recent decision by the U.S. Supreme Court has taken away the Federal Trade Commission's ("FTC's") most employed tool for seeking monetary relief: § 13(b) of the FTC Act. In *AMG Capital Management, LLC v. FTC*, the Court unanimously held that the FTC could not seek monetary relief, such as restitution or disgorgement, in federal court under § 13(b), without first completing its administrative process, subject to Commission and judicial review, and satisfying other conditions and limitations under § 19 of the FTC Act. *AMG Cap. Mgmt., LLC v. Fed. Trade Comm'n*, 141 S. Ct. 1341, 1344-45, 1351 (2021).

Section 13(b) was passed by Congress in 1973 and provides, in relevant part, "a temporary restraining order or a preliminary injunction may be granted," and "in proper cases the Commission may seek, and . . . the court may issue, a permanent injunction." 15 U.S.C. § 53. For decades, the FTC has sued companies in federal court under § 13(b) seeking not only an injunction, but also equitable monetary relief. Over the years, commenters, including amici curiae in *AMG*, have criticized this use of § 13(b) as dramatically altering the enforcement environment and parties' expectations, and as bypassing Congress's statutory scheme under §19. In *FTC v. Credit Bureau Center, LLC*, the Seventh Circuit created a circuit split when it held that § 13(b) does not allow the FTC to seek monetary relief. 937 F.3d 764, 767, 786 (7th Cir. 2019).

In *AMG* the Supreme Court followed the reasoning of the Seventh Circuit. The Court analyzed the statutory language of § 13(b) and emphasized the presence of prospective language such as "is violating" and "is about to violate," and the absence of retrospective language such as "has violated." 141 S. Ct. at 1348. The Court concluded that the language expressly providing only for prospective injunctive relief did not provide also for

retrospective monetary relief. *See id.* The Court also concluded that Congress would not have enacted § 19 if § 15 already provided for monetary relief without satisfying the requirements of § 19. *See id.* at 1349-51.

This holding is likely to have a significant impact on the FTC, as the agency has used § 13(b) to seek monetary awards in antitrust and consumer protection cases with growing frequency over the past forty years. *See id.* at 1346-47. The FTC's Acting Chairwoman Rebecca Kelly Slaughter referred to this ruling as a deprivation of "the strongest tool we had." *Statement by FTC Acting Chairwoman Rebecca Kelly Slaughter on the U.S. Supreme Court Ruling in AMG Capital Management, LLC v. FTC* (Apr. 22, 2021). In the past five years alone, the FTC's § 13(b) enforcement cases have resulted in the return of $11.2 billion to consumers. *Id.*

The FTC is already seeing an impact on its pending cases. As of April 2021, the FTC had 24 active federal court cases that relied exclusively on § 13(b) for monetary relief. These 24 cases represented $2.4 billion in potential recoveries. *The Consumer Prot. and Recovery Act: Returning Money to Defrauded Consumers*, *Virtual Hr'g Before Subcomm. on Consumer Prot. and Commerce*, *Comm. on Energy and Commerce,* 117th Cong. (Apr. 27, 2021). On the competition front, affected cases include the Martin Shkreli "Pharma Bro" matter in which defendants raised drug prices from $17.50 to $750, and a matter in which a district court awarded $493 million dollars in restitution to consumers harmed by inflated drug prices. *Id.* In *FTC v. Surescripts, LLC*, the FTC stipulated to withdraw its request for equitable monetary relief, without prejudice to its ability to seek leave to reinstate such request should Congress subsequently authorize the FTC to seek such relief. Case 1:19-cv-01080-JDB (D.D.C.), Dkt. 92, 93.

Congress's authorization of the FTC to seek monetary relief under § 13(b) is possible. Justice Breyer, writing for the Court, contextualized the holding in *AMG* with this very possibility by stating that "if the Commission believes that authority too cumbersome or otherwise inadequate, it is, of course, free to ask Congress to grant it further remedial authority." 141 S. Ct. at 1352. The FTC is, in fact, seeking Congress's passage of the Consumer Protection and Recovery Act, H.R. 2668, which would provide the FTC with the authority to seek equitable relief, including disgorgement. However, the bill is drafted to impose a new ten-year statute of limitations. While there appears to be bipartisan support for the bill, its terms continue to be discussed.

The FTC's efforts are not unprecedented. In *Kokesh v. SEC* and *Liu v. SEC*, the U.S. Supreme Court limited the Securities and Exchange Commission's ("SEC's") ability to seek disgorgement as a remedy. 137 S. Ct. 1635 (2017); 140 S. Ct. 1936 (2020). In 2021, Congress assented to the SEC's calls for legislative reform by passing § 6501 of the National Defense Authorization Act, amending § 21(d) of the Securities and Exchange Act, and expressly authorizing the SEC to seek disgorgement. 15 U.S.C. § 78u.

The FTC's timeline for potential reform of § 13(b) may be accelerated because it is occurring against the backdrop of other legislative efforts that are seeking to make sweeping changes to the antitrust laws. For example, Senators Mike Lee (R-UT) and Amy Klobuchar (D-MN) recently introduced the State Antitrust Enforcement Venue Act of 2021, and Senator Amy Klobuchar also introduced the Competition and Antitrust Law Enforcement Reform Act. With the active congressional hearings on § 13(b) and a legislative environment of sweeping antitrust reform, the response to *AMG* should be closely watched.

In the meantime, the FTC is not without significant power. It still may seek monetary relief in federal court under § 19, subject to its statute of limitations and other requirements. 15 U.S.C. § 57b; *see FTC v. Figgie Int'l, Inc.*, 994 F.2d 595, 598, 601, 606-07 (9th Cir. 1993). In addition, it may coordinate with state attorneys general, who may seek monetary relief under state law.

Energy Litigation Update

Going Straight to the Source: How Litigation Is Being Positioned To Prevent Export Credit Agencies from Financing Fossil Fuel Projects

Although climate litigation has already been brought in various forms in many countries around the world, NGOs and other interest groups are continuing to find new and innovative ways to challenge the legality of fossil fuel projects – with the latest litigation strategy aimed at attacking project financing.

Historically, the focus of climate litigation has been on the following:

1. Claims against companies involved in the processes of extracting, refining and selling fossil fuels, including in relation to the public disclosures made by those companies regarding their approach to climate change issues.
2. Claims seeking to force governments to take specific steps to work towards their emissions reductions targets. These include an injunction obtained by Urgenda Foundation against the Netherlands in December 2019, which compelled the Dutch Government to reduce its emissions, and successful claims by four environmental groups against France in February 2021 for failing to fulfil its obligations to mitigate global warning by decreasing greenhouse gas emissions.

This year has seen a new approach being taken by potential claimants, with a move towards using strategic

litigation against Export Credit Agencies (**ECAs**) to prevent them funding overseas fossil fuel projects. Those claims are seeking to leverage from nation states' obligations under international law to challenge the legality of funding fossil fuel projects, and to determine the manner in which pre-existing funding arrangements are managed going forward. By targeting the funding, rather than just the effects of the projects, interest groups are now starting to attack what they consider to be the true source of the problem – the economic support for the projects.

Two notable recent developments (which are considered in more detail below) are:

1. a substantive legal opinion commissioned by the campaign group, Oil Change International, which analyses the legal bases on which further action may follow against ECAs (the **Oil Change Opinion**); and
2. the English High Court's decision to grant permission to Friends of the Earth to commence a judicial review against UK Export Finance (**UKEF**) (the state-owned ECA of the UK) regarding its decision to fund a natural gas project in Mozambique.

ECAs and Their Funding of Fossil Fuel Projects

ECAs are typically established by nation states to help to create and support overseas opportunities for domestic exporters. Most G20 countries have at least one ECA, usually an official or quasi-official branch of government, which provides government-backed loans, credit, insurance and/or guarantees to support overseas infrastructure projects, including energy projects.

The conduct of ECAs is often directly or indirectly governed by certain international legal obligations (primarily because their conduct may be attributed to the nation state). In those circumstances, all the relevant international obligations binding on the nation state are arguably applicable to determine the lawfulness of the conduct of the ECA.

In terms of the scale of ECA funding, the Oil Change Opinion (at paragraph 7) states that, between 2016-2018: (a) ECAs from G20 countries provided USD 40.1 billion annually to support fossil fuel activities (coal, oil and gas across the upstream, midstream and downstream sectors) compared to only USD 2.9 billion for clean energy (solar, wind, geothermal, tidal); and (b) 78.6 percent of all ECA energy financing was given to fossil fuel-related projects/activities - representing an increase from the 76.6 percent given in the pre-Paris Agreement period (2013-2015). It is this sort of funding activity that interest groups want to prevent.

Legal Developments and Analysis

The key premise of the Oil Change Opinion is that there is a legal obligation on nation states (and, by connection, ECAs) to ensure that the projects they fund align with their commitments under the UN Framework Convention on Climate Change and the Paris Agreement.

It is argued that ECAs that support fossil-fuel related projects are failing to act in accordance with:

1. Article 2(1)(c) of the Paris Agreement, which requires nation states to make finance flows consistent with a pathway towards low greenhouse gas emissions and climate-resilient development;
2. the temperature goals laid down in Article 2(1)(a) of the Paris Agreement, which include pursuing efforts to limit the temperature increase to 1.5°C above pre-industrial levels; and/or
3. the requirements of Article 4 of the Paris Agreement, requiring nation states to pursue measures to mitigate climate change.

The Oil Change Opinion argues that, in accordance with these international laws, ECAs are required to stop financing new fossil fuel projects and to decrease the funding of existing fossil fuel projects. For example, it suggests that ECAs should proactively avoid locking-in fossil fuel-related emissions, as these are inconsistent with the progressive and ambitious approach required to satisfy the long-term strategies defined by the Paris Agreement.

A recent example of the how the above legal arguments are being used in a live claim can be seen in the Friends of the Earth action against UKEF, which is currently before the English High Court. In April 2021, Friends of the Earth was granted permission to pursue a judicial review allowing it to challenge UKEF's decision to provide around USD 1bn of taxpayer money to help finance Total's USD 20bn liquefied natural gas project in Mozambique's Cabo Delgado province.

In summary, Friends of the Earth's position is that UKEF:

1. made its decision to fund the project on the incorrect basis that it was consistent with the UK and/or Mozambique's commitments under the Paris Agreement; and
2. failed to consider essential issues, or carry out the necessary analysis, to determine properly if supporting the project aligned with the UK's and Mozambique's obligations under the Paris Agreement.

According to the Friends of the Earth website, a full hearing is expected to take place later this year.

The Future

The UKEF case should provide ECAs and other sector participants with greater clarity about how funding decisions made by ECAs are impacted by the Paris Agreement and English law (if at all). Nevertheless, a

number of major European ECAs have shown that they are not willing to wait for the outcome of that case and have, instead, already taken proactive steps to head-off future litigation. For example, UKEF has vowed not to provide any further financing for oil, gas or thermal coal projects from 31 March 2021, and in April 2021 a new alliance, the Export Finance for Future coalition (the **E3F Coalition**) (comprising Denmark, France, Germany, the Netherlands, Spain, Sweden and the UK), formally committed to ending ECA support for fossil fuel projects generally.

Interestingly, while those developments will likely reduce the risk of litigation against future decisions by ECAs from nation states involved in the E3F Coalition, they will not prevent action being taken against ECAs (a) in relation to their historic funding decisions (including how they continue to operate existing funding facilities), or (b) from nation states that have not made equivalent commitments to the E3F Coalition.

As a result of the continuing threat to ECAs, companies that have received (or are due to receive) the benefit of ECA funding for fossil fuel projects would be wise to reassess their own funding arrangements. In particular, companies should consider what impact the UKEF case could have on their projects (assuming the Friends of the Earth judicial review is successful), as well as how other legal arguments could be framed to challenge the legitimacy of the ECA funding they have received or are hoping to receive in due course.

Finally, if the risks associated with ECA funding become too great, it may be that companies in the fossil fuel sector turn exclusively to other financial institutions to provide financing for their projects (noting that it is already estimated that the world's largest 60 banks have provided USD 3.8 trillion of financing for fossil fuel companies since the Paris Agreement was signed in 2015). However, given that a number of the banks have recently announced their own commitments to aligning financing portfolios to the goals of the Paris Agreement, it may be that, in those circumstances, NGOs and other interest groups simply re-direct their strategic legal efforts away from ECAs and towards finding a new legal route through which to hold the financial institutions to their newly stated climate change commitments.

Asia-Pacific Litigation Update

'*Shifting Sands*': Adopting Contingency Fees in Australian Class Actions

Introduction

Unlike the United States, Australia has historically prohibited (and for the most part, continues to prohibit) contingency fees in any type of litigation. This includes Australian class actions. The consequence has been that litigation funders have adopted a direct funding structure, whereby a percentage of the amount awarded for that proceeding can be claimed by the litigation funder as a "commission". The viability of these funding structures has come under recent threat due to legislative and judicial intervention in the litigation funding of class actions. At the same time, at least one Australian State (and perhaps the Federal Court of Australia) have rolled back the prohibition on contigency fees in class actions. This note considers how this position has been arrived at and its implications for the funding of class action litigation in Australia.

The Historical Opposition to Contingency Fees

Contingency fees have long been considered anathema to Australian litigation. Section 183 of the *Legal Profession Uniform Law* (NSW) (***Uniform Law***) stipulates that a law firm may not enter into an agreement where its fees are calculated by reference to the actual amount recovered in the proceedings. Contravening that provision has stern penalties that sound in substantial fines and can lead to a finding of unsatisfactory professional conduct or professional misconduct for the legal practitioners involved. Equivalent provisions exist in every State and Territory of Australia.

The perceived problem with contingency fees in Australia is that it puts attorneys in a potentially conflicted position with respect to their duties to the court and their clients—it is said that by holding what can be a (significant) personal stake in the litigation, their judgement may be clouded by the financial incentives before them. It might, for example, impede their ability to give full and frank advice to their client on the prospects of success of the case. That is a particular concern for Australian practitioners where, unlike the United States, unsuccessful parties are usually ordered to pay the costs of the successful party.

Of course, if financial incentives based on success are the reason for the opposition to contingency fees, the argument unravels quickly. Attorneys are, under the existing rules, entitled to charge at least a 25% uplift on the fees that they incur on a conditional basis in Australian litigation. If we are prepared to allow attorneys to carry some financial risk in a litigation, then the danger that purportedly justified the prohibition of contingency fees has already been realized. All that is left is a the question of the scale of that investment—and even then, some "no-win no-fee" class actions have had fees awarded in the order of $40 million: see, eg, *Cantor v Audi Australia Pty Ltd (No 5)* [2020] FCA 637.

With the above in mind, this paper describes how the model for litigation funding of class actions in Australia has rapidly evolved over the past 3 years, and

how contingency fees will likely play in increasing role in the future, as a new mechanism for a claimant's access to justice in light of the judicial excision of the "Common Fund Order" (**CFO**) that had, until recently, supported funding of Australian class actions.

Recent Flux in Funding Orders

Historically, there have been two basic ways class actions are funded in Australia (other than by the claimants themselves): *firstly*, a firm of attorneys can run the matter in a speculative "no win no fee" manner (that is their fees and perhaps disbursements would only be payable out of any successful outcome) and they would then be entitled to at most a 25% uplift on their deferred fees at the end of the case; *secondly*, since the High Court's decision in *Campbell's Cash and Carry Pty Limited v Fostif Pty Ltd* (2006) 229 CLR 386, a litigation funder can enter into an agreement with the lead plaintiff to meet the costs of the representative proceedings.

Prior to 2016, remuneration for the appointed attorneys and any litigation funder were dealt with by way of standard contractual principles—*i.e.*, the attorneys and/or funders would enter into individual agreements with as many of the group members as they could. By that contract, the Court (which is obliged to approve any settlement of a class action, including as to the fees and funding charges) could approve the settlement and therefore the fees and funding charges as between those parties. However, this approach to funding created a "free rider problem", whereby group members who did not sign-up to the funding agreement would—in theory—be entitled to their share of the proceeds of the action but without the need to pay their proportionate share of the costs incurred to receive it.

The first solution was to create a "funding equalization order". This meant that the amount that would have to be paid by the contracting parties to the lawyers and litigation funder (including any commission of the litigation funder) would be set by reference to those contracts, but then each of the group members would be obliged to contribute their share of that amount: *see, e.g., Money Max Int Pty Ltd (Trustee) v QBE Insurance Group Limited* (2016) 338 ALR 188 (***Money Max***). This however left open the risk that if insufficient group members sign the funding agreements, the economic return for the litigation funder could be disproportionate to what they would have expected to receive had every group member signed up.

A solution to this problem was crafted by the Full Court of the Federal Court in *Money Max*. The Court devised the CFO so that, instead of requiring each person to enter into a funding agreement with the litigation funder, the Court was empowered, under s 33ZF of the *Federal Court of Australia Act 1976* (Cth) (which allows the Court to make any order it sees fit to ensure that justice is done in the proceeding), to order that each group member, irrespective of whether they have signed a funding contract with the litigation funder, would be obliged to pay the litigation funder the amount specified in a Court's order.

The impact of this order was immediate—it allowed litigation funders to invest in class actions without the need to conduct any real "bookbuild" exercise first. Naturally, this had the effect of drastically increasing the number of litigation funders (and capital available) in the Australian market. In 2018, BMW, one of the defendants in the Australian incarnation of the Takata class actions, applied for the determination of a separate question to the NSW Court of Appeal that an interlocutory CFO was either beyond the scope of the NSW equivalent of s 33ZF and/or was unconstitutional. That question was heard alongside an appeal to the Full Court of the Federal Court from the making of an "interlocutory" CFO. In an Australian first, three judges of the NSW Court of Appeal and three judges of the Full Court of the Federal Court sat together and then jointly held 6-0 that CFO were neither beyond power nor unconstitutional: *Brewster v BMW Australia Ltd* (2019) 366 ALR 171; *Westpac Banking Corporation v Lenthall* (2019) 265 FCR 21.

That judgment was then appealed to the High Court of Australia which—in a surprise decision—held 5-2 that interlocutory CFOs were beyond the scope of s 33ZF: *BMW Australia Ltd v Brewster* [2019] HCA 45 (***BMW v Brewster***).

The rise and fall of CFOs in Australia occurred in a period of around three years. But despite *BMW v Brewster*, the saga of the CFO is not yet complete. Presently, the Federal Court at least, has begun making orders under the settlement approval power (s 33V(2)) to approve settlements that include arrangements in the nature of CFOs: *e.g.*, Lee J implementing a "Settlement CFO" in *Asirifi-Otchere v Swann Insurance (Aust) Pty Ltd (No 3)* [2020] FCA 1885, and further *Evans v Davantage Group Pty Ltd (No 3)* [2021] FCA 70 at [49], where Beach J expressly stated that the decision in *BMW v Brewster* did not limit the Court's power to make a CFO-like order under s 33V(2). Nonetheless, uncertainty has again begun to creep into the Australian funding market for class actions.

Adding to this uncertainty, the conservative Australian Federal Government and corporate Australia has grown increasingly antagonistic towards the financing of class actions, and litigation funders in particular. Consequently, in the last 18 months there have been a number of reports and Parliamentary inquiries into class actions and the class action regime. In addition, in mid-2020, the Australian

Federal Government actively sought to clamp down on class action litigation:

- First, with respect to shareholder class actions, it introduced a temporary (and now permanent), amendment to a corporation's continuous disclosure obligations under the *Corporations Act 2001* (Cth). This changed the nature of the breach of the obligation to disclose from a mere failure to disclose material information sounding in breach to only those failures where "the entity knows or is reckless or negligent" as to the failure to disclose: ss 674A and 675A of the *Corporations Act*. The idea behind this move was to make it more difficult (ostensibly at first to assist companies to manage the risks posed by COVID-19) to commence shareholder class actions.
- Second, in August 2020, the Australian Federal Government amended the *Corporations Regulations 2001* (Cth) to remove the exemption for litigation funders of class actions from having to comply with the requirements for managed investment schemes (**MIS**). As a result, for any class action commenced after August 22, 2020, the litigation funder would have to hold an Australian financial Services License (**AFSL**) and the litigation itself would have to comply with the rules relating to MIS, including the publication of a prospectus and abidance with the anti-hawker provisions. It is noteworthy that defendants to class actions have already sought to take advantage of these changes by challenging the funding arrangements of class actions, and has led at least one Federal Court judge to remark that the MIS regime "doesn't work".

It is not surprising therefore that traditional litigation funding models for class actions have become increasingly clouded and difficult to navigate. It also means that proceedings funded on a direct financing model and commenced post-August 2020 are far less flexible in their funding structures. This presents a particular problem for these models where competing class action proceedings are commenced. Due to the opt out structure of Australian class actions, lead plaintiffs can commence identical, overlapping proceedings that ostensibly seek the same damages as those already on foot. As defendants should not be "vexed" with multiple proceedings (*see McKay Super Solutions Pty Ltd (Trustee) v Bellamy's Australia Ltd* [2017] FCA 947), and in the absence of any statutory procedure for selecting which lead plaintiff should proceed, the Courts have developed a "multi-factorial" process to assess which class action should proceed: *Perera v GetSwift Limited* [2018] FCA 732; *Wigmans v AMP Ltd* [2019] NSWSC 603. While ostensibly based on a number of factors (*see Perera v GetSwift Limited* [2018] FCA 732), the primary factor is the expected cost of the proceedings and the return to group members: *see Wigmans v AMP Ltd* [2019] NSWSC 603; *CJMcG Pty Ltd as Trustee for the CJMcG Superannuation Fund v Boral Limited (No 2)* [2021] FCA 350 (***Boral***). The High Court (in a 3-2 decision) has recently approved of this multifactorial analysis that places the expected costs at the heart of the decision of which proceeding should continue: *Wigmans v AMP & Anor* [2021] HCA 7 (***Wigmans***). Given that, superficially at least, it often appears that a funded model is more expensive than a no-win no-fee model (*Boral* at [66]), this leaves funded proceedings vulnerable to competing proceedings commenced on a no-win no-fee basis.

This shift in the law begs the question: How can traditional litigation funding of class actions move forward?

The answer is that it can only move forward by evolution and, in that respect, in an evolution towards a U.S. model of 'portfolio financing'. The challenge of course is making that financially viable for both funders and lawyers where the only recovery (absent a direct funder who is entitled to charge a commission) can be the costs incurred in the proceedings plus an uplift on attorney fees—this naturally leads to a reconsideration of the legality of and role for contingency fees in class action proceedings.

Australian Contingency Arrangements

There has been some notable progress towards the acceptance of contingency fees in Australia. On June 18, 2020, the Victorian Parliament (based on recommendations from the Victorian Law Reform Commission (**VLRC**)) passed legislation that appeared to have the effect of legalizing contingency fees (called "Group Costs Orders" (**GCO**)) for class actions where the Court is "satisfied that it is appropriate or necessary to ensure that justice is done in the proceeding": s 33ZDA of the *Supreme Court Act 1986* (Vic) (**SCA**).

The first decision on the question of whether a GCO should be made was handed down on 14 September 2021: *Fox v Westpac; Crawford v ANZ* [2021] VSC 573 (***Fox***). The Court refused to make a GCO. In short, the Court found that a GCO was not necessary to ensure that justice is done in the proceeding because the lawyers for the plaintiff had entered into a binding retainer to conduct the proceeding on a no-win no-fee basis. That is, if the GCO were refused, the plaintiffs would not be forced to find litigation financing elsewhere. While *Fox* provides an important insight into the criteria necessary for establishing when a GCO might be ordered, the fact that the decision turns on the structure of the lawyer-client relationship means it is of less use in understanding how the Supreme Court of Victoria will approach the question of quantification of the GCO. It still remains

to be seen whether the Supreme Court of Victoria will approve settlements and contingency fees that represent significant uplifts for law firms, or whether the amount to be awarded will reflect a lodestar to the fees that were (or would have been) incurred in the proceeding.

The movement in favor of contingency fees is gathering momentum even without a legislative imprimatur. In *Boral*, Lee J noted at [50] (and citing an earlier decision in *Klemweb Nominees Pty Ltd (as trustee for the Klemweb Superannuation Fund) v BHP Group Ltd* (2019) 369 ALR 583, that:

> "I do not consider it unlikely that a common fund order incorporating a contingency payment [to a firm of solicitors] could be made. When one has regard to the equitable roots and restitutionary basis of common fund orders, it is not apparent why a common fund order incorporating a contingency component is antithetical to doing justice in a [class action] in an appropriate case."

In short, his Honor appears to consider that the Federal Court can achieve a similar outcome to the Victorian legislation by making orders permitting such an arrangement.

What these developments suggest is that Australia is beginning a transition towards more flexible (albeit, presently, more uncertain) funding arrangements for class actions. There are risks and benefits to this approach, and scrutiny from the Court (as well as the development of consistent principle) will be essential. Nevertheless, contingency arrangements will (and in some cases already do) present an opportunity for class actions to be pursued with both transparent and Court-monitored funding arrangements. That, in turn, should give some confidence to litigants that they will be protected from unfair financial outcomes, and for litigation funders that there can be some certainty of a return on their investment.

VICTORIES

A Victory for Deal Certainty

On April 30, 2021, Quinn Emanuel obtained a complete victory in the Delaware Court of Chancery for its clients, Plaintiffs Snow Phipps Group and DecoPac, in *Snow Phipps Group, LLC, v. KCAKE Acquisition, Inc.*, Case No. 2020-0282-KSJM. Describing the decision as a "victory for deal certainty," the Court resolved all issues in favor of the Plaintiff seller and ordered the buyer, Kohlberg & Co., to close on the $550 million transaction.

This case marked only the second so-called "busted deal" case to go all the way to trial and judgment in Delaware Chancery Court in the COVID-19 era. (Quinn Emanuel also tried and won the other case, *AB Stable VIII LLC v. MAPS Hotels and Resorts One LLC*, C.A. No. 2020-0310-JTL, for its client Mirae Asset.) This dispute concerned a buyer's failed efforts to scuttle the sale of leading cake decoration supplier, DecoPac. In March 2020, at the outset of the pandemic, Kohlberg & Co. entered into an agreement with Snow Phipps Group for the purchase of DecoPac and agreed to use its reasonable best efforts to consummate debt financing. Soon after signing, with government stay-at-home orders increasing and DecoPac's sales declining, Kohlberg & Co. developed a case of buyers' remorse. Although DecoPac's sales quickly recovered, Kohlberg sought to terminate the transaction, claiming that its committed debt financing was no longer available; that DecoPac was likely to experience a Material Adverse Effect (MAE); and that DecoPac had been operating outside of the ordinary course of business. This litigation ensued, with Plaintiffs seeking to enforce the specific performance provision of the purchase agreement to close the transaction and Defendants seeking to escape the deal, arguing that the Court could not order specific performance in the absence of fully-funded debt financing.

Following a five-day trial in January 2021, the Delaware Court of Chancery resolved all issues in favor of the Plaintiffs and ordered Kohlberg & Co. to close on the transaction for the agreed purchase price of $550 million. In its 126-page opinion, the Court found in favor of Plaintiffs and concluded that Kohlberg & Co. had "set on a course of conduct predestined to derail Debt Financing and supply a basis for terminating the agreements." The Court held that Kohlberg & Co. contributed materially to the lack of debt financing by breaching its obligation to use reasonable best efforts to obtain financing and, invoking the prevention doctrine, the Court ordered specific performance. The Court also found that Plaintiffs proved that DecoPac did not suffer an MAE, given the durational insignificance and immateriality of the sales declines, and even if it had, the agreement's MAE carve-out provision for events "related to" government orders applied and DecoPac had not suffered disproportionately compared to its peers. Finally, the Court soundly rebuffed any arguments that DecoPac had operated outside of the ordinary course of business, noting that many of Defendants' arguments on ordinary course had been waived.

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business litigation report

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