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LEHMAN BROTHERS: THE FAILURE OF THE LEGAL GATEKEEPER

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LEHMAN BROTHERS

This essay concerns the question of what could have been done by the lawyers who were in a position to act as professional sentinels or gatekeepers, and may have prevented Lehman Brothers from moving \$50 billion of debt off its balance sheet at the end of each quarter; and replacing the debt with cash in the repurchase market. The thesis is that the misrepresentation of Lehman's total debts, which resulted in the collapse of trust in global financial repurchase markets, an event widely regarded as the catalyst for the global financial crisis, could have been prevented by the legal professionals who facilitated the transaction. The New Yorker Magazine reported:

“The big news in the [Lehman bankruptcy] report, in case you missed it, is that Lehman, in the months before it went under, used accounting trickery to shift about fifty billion dollars off its balance sheet—an exercise that reduced the leverage ratios it reported, thereby misleading investors about its true financial condition.”¹

In the same article, the author refers to the process of raising large sums of cash just before the end of each reporting period, thereby bolstering the amount of cash reported on the balance sheet, in the following terms:

“An acrimonious legal battle beckons over whether the tactics that Lehman used were illegal, or merely dodgy. These tactics involved pretending to sell tens of billions of securities to other firms just before the accounting deadline, thereby bolstering the amount of cash the firm appeared to be holding, and then buying [back] the assets immediately after the deadline. The U.K. law firm of Linklaters signed off on these sham transactions—several U.S. firms refused to do so, according to Valukas—and Ernst & Young, Lehman's accountant, didn't raise any objections, either.”²

When the author commenced writing this article, the intention was to use the Lehman's failure

¹ Cassidy, John, 'The Lehman Report: Is It Time for a Special Prosecutor?' New Yorker Magazine, 16 March 2010

² Ibid.

to provide a touchstone for speaking to each of the public market gatekeepers, including, rating agencies, analysts, merchant banks, auditors, valuation experts, lawyers, exchanges, as well as regulatory agencies. The *Examiners Report*³ on the Lehman Brothers failure is largely concerned with the failure of Ernst & Young to properly account for Lehman's liabilities and the culpability of Lehman's Directors and Officers who signed off on a series of 'colourable transactions'.⁴ Little has been written about the role of preeminent British law firm, Linklaters in the Lehman failure. US firms would not sign off on the Lehman transactions, but Linklaters did. The transactions have been characterized by some as 'sham transactions'. The focus of this essay will be the Linklaters 'true sale opinion letter'⁵ that was required by Lehman Brothers in order to **dress up** the Lehman Brothers balance sheet at the end of each quarter leading up to its ultimate failure in September of 2008. The author hopes to analyze the bona fides of the transaction from the perspective of the Linklaters opinion letter, and the role Linklaters played as legal gatekeepers to public markets. The author will also suggest certain legislative changes that may help to prevent the kind of market upheaval precipitated by Lehman Brothers apparent lack of probity in its dealings with global financial markets.

MACDONALDS DRIVE THROUGH:

There are times in history when the failings of key members of our society are brought in to sharp focus. The failure of Lehman Brothers, and the ensuing chaos in 'global financial markets,' is just such an occasion. Mohamed El-Erian, the CEO of PIMCO⁶, the world's largest mutual fund, in an interview with CNN, explained why "the collapse of Lehman Brothers destroyed confidence in the global economy"⁷ and resulted in the collapse of global financial markets. Mr. El-Erian used the analogy of a Macdonald Restaurant where a drive-through customer orders and then drives up to the first window where he pays; after which the

³ *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas Volume 3 at 1291

⁴ *Ibid.* at 1292 to 1295

⁵ Firth, Simon, 'Lehman Brothers True Sale Opinion Letter' Linklaters 31 May 2006 The Opinion Letter is attached in its entirety at Exhibit 'A'.

⁶ http://money.cnn.com/video/fortune/2009/12/08/f_cs_pimco_food.fortune/ The Pacific Investment Management Company, LLC (PIMCO) is the world's largest mutual fund. PIMCO was founded in 1971 in Newport Beach, California, with just US\$12 million and reached US\$1.0trillion in assets in January 2010. *Ibid.*

customer collects his food at the second window. El-Erian poses the question, “Imagine what would happen if you had cash but you weren’t sure if you were going to get your burger at the second window?” He asserts that you wouldn’t part with your cash but instead would insist on first getting your burger. El-Erian explains that the second window is the ‘global financial market’ equivalent of repurchase and securities transaction ‘settlement’⁸. El-Erian says that cash-rich institutions like PIMCO would normally put their cash in to the repurchase market for an overnight return but suddenly were not only unsure about whether they would get a return on their cash, they weren’t sure whether the cash would be returned. Mr. El-Erian asserts that the system failed because “no one trusted the 10 yards between the first and second windows...”⁹ In other words, financial institutions around the world lost confidence when it became known that Lehman Brothers did not actually have the financial equivalent of a burger at the second window.

El-Erian points out that the financial system works because there is trust. Buyers part with their cash because they trust there’s a burger waiting at the second window. Lehman Brothers undermined trust¹⁰.

Mr. El-Erian in the same interview goes on to point out that the consequence of the loss of trust and freezing of credit markets in the last quarter of 2008, led to an 86% decline in machinery orders in Japan; a 46% decline in exports from China; and a 90% decline in industrial output in Russia¹¹. Economic indicators like these and many more were not seen during the Great Depression of 1929.¹²

MARKETS BY THE NUMBERS

The failure of Lehman Brothers provides an unprecedented opportunity to study the failings of a Global Investment Banking institution, which would normally be considered a public

⁸ Ibid.

⁹ Ibid.

¹⁰ http://money.cnn.com/video/fortune/2009/12/08/f_cs_pimco_food.fortune/

¹¹ Ibid.

¹² Carswell, Andrew, ‘*Global Financial Crisis Worse than Great Depression*’ Adelaide Now, News Ltd 11 December 2008

market gatekeeper,¹³ and the putative legal underpinnings of that failure. The author will endeavor to delineate the connection between financial markets, banks, the US Federal Reserve, the US Treasury's securities, and the law as it relates to the obligations of legal professionals who act as sentinels and gatekeepers to public and financial markets for events ranging from the facilitation and control of money supply and interest, to the movement of capital between financial institutions around the world.

The story must start with the approximately US\$55,700 billion in total global sovereign debt¹⁴; US\$12,700 billion in total US government debt¹⁵ including unfunded pension and social security liabilities; US\$8,200 billion in US Treasury¹⁶ issued debt of which less than US\$5,000 billion is held by foreign governments¹⁷ (more than \$800 billion of that is held by the Peoples Republic of China); US\$5,000 billion per day in cash exchange and repurchase contracts in 2008 prior to the crash¹⁸; US\$1,000 billion in accumulated counter-party trading liability that had been contracted by Lehman Brothers as at the day it filed for Chapter 11 Bankruptcy protection¹⁹; US\$640 billion in Lehman Brothers debt obligations²⁰ at the time of bankruptcy filing; and finally, US\$50 billion in assets used by Lehman Brothers²¹ as security for loans that may have been improperly characterized as 'true sales', in order for Lehman Brothers to raise cash, improve its balance sheet, access public financial markets, and to forestall its bankruptcy.²²

The questions must be asked: What happened that Lehman Brothers were permitted to undermine trust or confidence in global financial markets? Was the failing of Lehman Brothers entirely that of Lehman's management? Were there others who contributed to that

13 Coffee John C, *Gatekeepers* 2006 Oxford University Press

14 <http://dsbb.imf.org/Applications/web/sddsiipage/> (See table of Sovereign Debt at Exhibit "A")

15 <http://www.treasurydirect.gov/NP/BPDLogin?application=np>

16 <http://www.treasurydirect.gov/NP/BPDLogin?application=np>

17 <http://www.treas.gov/tic/mfh.txt>

18 Steiner-Threkeld, Tom, 'Tri-party Repo Reform Focuses on Operational Improvements', *Securities Industries News Source Media*, December 22 2009

19 *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas at 214

20 *Ibid.* at 645

21 *Ibid.* at 1620

22 Reinhardt, Uwe E, 'Financial Accounting & Decency' *New York Times* 19 March 2010

failure? Were there any participants in the Lehman transactions who might have prevented Lehman Brothers from misrepresenting the truth of its total liabilities?

GATEKEEPER DEFINED

What is a financial market sentinel or gatekeeper? Who are the private sector sentinels of public companies? How did the failure of two gatekeepers act as a catalyst for the global financial crisis? The subject is vast and while the author will attempt to contextualize the role of professional and non-professional gatekeepers, it will not be possible to fully map out the roles and failings of each gatekeeper or the underlying failure of the regulators to regulate the nature, complexity and volume of certain core inter-bank financial transactions until credit markets seized in the autumn of 2008. The author will endeavor to impart a basic understanding of the nature of inter-bank funding and monetary policy. This will require a somewhat detailed analysis of repurchase (“Repo”) contracts and their various iterations. Ultimately Repo contracts will be contextualized with the legal definition of a ‘true sale’ of financial securities, versus a loan collateralized by the same securities. The author will attempt to cover some of the core obligations of audit professionals when preparing books of accounts and undertaking audits for the purpose of filing public company financial statements. However, the primary focus of this essay will be on the obligations of a legal professional when preparing a ‘legal opinion letter’ which is relied on for the preparation of accounting records of a publicly traded merchant banking company, and how the failure of a single law firm, as the gatekeeper to that global merchant bank, namely Lehman Brothers, forestalled the bankruptcy of Lehman Brothers but in so doing ultimately precipitated the loss of confidence in global Repo markets that resulted in the unprecedented seizing of global financial markets.

Linklaters opined that the exchange of US\$50 billion in mixed liquid and illiquid assets for cash through GCF repurchase contracts at the end of each quarter were ‘true sales’ under English law. As Mohammed El-Erian points out, this was the catalyst for a global loss of confidence between banks that would cause global credit markets to freeze up and in so doing cause a financial crisis that was far more apocalyptic than the Great Depression.²³

²³ Wall Street Journal, Wednesday, September 17, 2008, Front Page

SHAM TRANSACTION

Was Lehman's transfer of US\$50 billion in assets from the US to the UK, in order to receive more favorable accounting treatment, a sham? The leading common law authority for what constitutes a 'sham transaction' is *Snook v London & West Riding Investments* where Lord Diplock states:

"It is, I think, necessary to consider what, if any, legal concept is involved in the use of this popular and pejorative word. I apprehend that, if it has any meaning in law, it means acts done or documents executed by the parties to the "sham" which are intended by them to give to third parties or to the court the appearance of creating between the parties legal rights and obligations different from the actual legal rights and obligations (if any) which the parties intend to create".²⁴

The leading case in the US on what constitutes a 'sham transaction' is the Supreme Court's decision in *Gregory v. Helvering*, a case of setting up a company, and shifting assets from one company to another, to avoid federal income tax.²⁵ The authorities on 'sham transactions' in the US are almost entirely tax decisions, however, Lord Diplock helpfully informs us that a 'sham transaction' is not merely a concept of tax law, or trust law, but is a concept of the general law.²⁶ Lord Diplock States:

"But one thing, I think, is clear in legal principle, morality and the authorities ... that for acts or documents to be a "sham," with whatever legal consequences follow from this, all the parties thereto must have a common intention that the acts or documents are not to create the legal rights and obligations which they give the appearance of creating. No unexpressed intentions of a "shammer" affect the rights of a party whom he deceived."²⁷

²⁴ *Snook v London & West Riding Investments* [1967] 2 QB at 801 per Diplock LJ

²⁵ *Gregory v Helvering* 293 U.S. 465 (1935), 69 F.2d 809 (2d Cir. 1934).

²⁶ *Snook v London & West Riding Investments* [1967] 2 QB at 801

²⁷ *Snook v London & West Riding Investments* [1967] 2 QB at 802

Put in succinct terms, a transaction is a sham where the parties say or do one thing but intend something else altogether.²⁸ The UK courts subsequently endeavored to set out the parameters of a sham transaction. The High Court of Australia has specifically considered the legal meaning of sham²⁹ and concluded that a transaction is no sham merely because it is carried out with a particular purpose or object. If what is done is genuinely done, it does not remain undone merely because there was an ulterior purpose in doing it."³⁰ The High Court points out that a sham involves more than one step in a transaction; the transaction takes the form of, or appears to be, legally effective; and the parties to that transaction intend that its legal consequences should be, different to what they seem; or that it not have any legal consequences.

The most recent decision on 'sham transaction' is *Hitch v Stone*, where Arden LJ sets out five steps for judicial determination of what should be considered a sham:

1. The court may look beyond the four corners of the contract documentation. It may examine external evidence. This will include the parties' explanations and circumstantial evidence, such as evidence of subsequent conduct of the parties.
2. The test of the parties' intention is subjective. The parties must have intended to create different rights and obligations from those appearing from (say) the relevant document, and in addition they must have intended to give a false impression of those rights and obligations to third parties.
3. The act or document/s may be uncommercial, or even artificial, but that does not necessarily mean the transaction is a sham. A distinction is made to bind them. In the first scenario, the parties intend the agreement to take effect according to its tenor. In the second scenario the documents do not actually bind their relationship?
4. A departure from the contract documents does not necessarily mean that the contracting parties never intended the agreement to be effective and binding.
5. The intention of the contracting parties to create a sham must be a common intention.³¹

28 *Donald v Baldwyn* [1953] NZLR 313, 321, per F B Adams J; *AG Securities v Vaughan* [1990] 1 AC 417 per Bingham LJ

29 *Equuscorp Pty Ltd v Glengallan Investments Pty Ltd* [2004] HCA 55

30 *Miles v Bull* [1969] 1 QB 258 at 264

31 *Hitch v Stone (Inspector of Taxes)* [2001] STC 214 64 to 65

Before moving to an analysis of the transaction and whether the legal consequence is different from what was documented or intended by Lehman management, the author notes that at paragraph 3, page 3 of the Linklaters 'opinion letter' Lehman Brothers are warned as follows:

“However, a court would look at the overall arrangements to determine whether a transfer should be classified as a sale or as a charge where it is alleged either that the terms of the documentation by which the assets were transferred had been supplemented or modified by provisions in other documentation or else that the sale documentation was a “sham”.³²

REPURCHASE AGREEMENTS

What is a Repurchase Agreement? Repurchase contracts are the mechanism by which central banks create or reduce liquidity and are also the mechanism by which commercial banks gain short-term access to liquidity from other banks around the world, or alternatively earn interest on short-term surplus cash. The term was first defined in the United States Third Circuit Federal Court as follows:

“A standard repurchase agreement, commonly called a ‘repo,’ consists of a two-part transaction. The first part is the transfer of specified securities by one party, the dealer, to another party, the purchaser, in exchange for cash. The second part consists of a contemporaneous agreement by the dealer to repurchase the securities at the original price, plus an agreed upon additional amount on a specified future date. A "reverse repo" is the identical transaction viewed from the perspective of the dealer who purchases securities with an agreement to resell.”³³

The repurchase (hereinafter described as “Repo” or “RP”) agreement when employed between banks allows a liquid security to be used to secure the cash that is needed by that

32 Firth, Smon, Linklaters ‘Opinion Letter to Lehman Brothers International Europe’, 31 May 2006 at 3

33 *Bevill, Bresler & Schulman Asset Mgmt. Corp. v. Spencer S&L Ass'n. (In re Bevill, Bresler & Schulman Asset Mgmt. Corp.)* 878 F.2d 742, 743 (3d Cir. 1989)

institution to fund its short term cash needs. When the funding mechanism is used between banks it is called a General Collateral Finance (“GCF”) repurchase agreement.

The US Federal Reserve, the Bank of England, the Reserve Bank of Australia, the European Central Bank and Central Banks throughout the world use RP agreements to control interest rates and money supply through the exchange of government securities issued to primary dealers³⁴ for cash provided by the Federal Reserve Bank, on the promise that these securities will be repurchased by the Primary Dealers at some later date. Central Banks increase or decrease both interest rates and liquidity by setting longer or shorter repurchase periods or interest rates. The Bank for International Settlements has reported:

“Repo markets are a vital source of secured financing for banks and financial institutions, and a key tool for the implementation of monetary policy.”³⁵

For that reason a fully functioning RP market is pivotal to a sound global financial market. The daily volume of cash exchange and repurchase transactions just prior to the onset of the Global Financial Crisis in late 2008 was stated to be approximately \$5,000 billion per day:

“... two banks clear the majority of the \$5 trillion in cash and securities that underlay [the] Treasury market. They are J.P Morgan Chase and Bank of New York Mellon. These two banks typically take on the counterparty risk of each repo agreement, by extending credit or collateral to participants. The counterparties are normally two dealers or a dealer and a fund manager. At peak levels in 2008, more than \$2.8 trillion in securities were being financed through repo transactions. According to the task force, many of the repo transactions had “very short maturities” and involved the “daily transfer of nearly the full amount” in cash or securities from the accounts of J.P. Morgan Chase and Bank of New York Mellon.”³⁶

34 Table One, Exhibit “A”

35 King, Michael R, Hördahl, Peter, BIS Quarterly Review, December 2008

36 Steiner-Threkeld, Tom, ‘Tri-party Repo Reform Focuses on Operational Improvements’, Securities Industries News Source Media, December 22 2009 at 2

The US Federal Reserve Bank is empowered to enter into RP contracts with reversal dates as little as one day and much as 65 days. The Bank of England and the European Central Bank can enter into RP contracts with the Federal Reserve Bank for periods up to 84 days.

The United States Treasury Department auctions its bonds to Primary Dealers³⁷ every business day. Primary dealers do not purchase the securities for cash but rather commit to pay the Treasury the face value of the security at some later date. (The Treasury may then redeem these promises to pay from its Primary Dealers for cash from the Federal Reserve Bank. These are what are known as Tri-party Repo Contracts.³⁸) Primary Dealers may then re-sell these treasuries to the Federal Reserve Bank or to other counter-parties. When the treasuries are sold by Primary Dealers to the Federal Reserve Bank they are sold using RP contracts where the repurchase period can be as little as one day or as long as 65 days. It should be apparent that the larger the number of RP contracts or the longer the repurchase period, the greater the money supply in the US economy. Because the US generally employs a 20% commercial bank reserve ratio, money supply increases at a rate inverse to the reserve ratio, namely 5 times the rate at which money is released by the Federal Reserve Bank through repurchase contracts. This is known as the money multiplier effect.³⁹

Money supply and interest rates can thus be adjusted by adjusting the volume and duration of RP contracts. In other words, by extending or limiting the date by which Dealer must repurchase the securities which underpinned the RP contract⁴⁰. Conversely the Federal Reserve Bank can take money out of the economy by reversing the relationship between Treasury notes and the duration and volume of repurchase contracts with the Federal Reserve Bank.

It should be apparent that the RP contract, in various forms is a legal instrument that is a core tool for governments to control monetary policy. It should therefore be self-evident that the

37 Table One attached as Exhibit "A"

38 Steiner-Threkeld, Tom, 'Tri-party Repo Reform Focuses on Operational Improvements', Securities Industries News Source Media, December 22 2009 at 14

39 Krugman & Wells, Money, Banking, and the Federal Reserve System: Reserves, Bank Deposits, and the Money Multiplier, 2009 pp 393–396

40 Fleming, Michael J, Garbade, Kenneth D, 'The Repurchase Agreement Refined: GCF Repo' Current Issues in Economic and Finance Volume 9, Number 6 June 2003

obligations that are attached to the construction of these contracts, and their discharge are of critical importance to the normal functioning of financial markets. It is against this backdrop that the role of gatekeepers will be analyzed.

PUBLIC MARKET SENTINEL

There are eight gatekeepers⁴¹ for a publicly traded company, including the government regulator. There are ten for a publicly traded merchant bank, including three separate government relatory agencies.⁴² The author will deal with the private sector gatekeepers and the professional gatekeepers with particular focus on the legal professionals that facilitated the RP contracts which ultimately lead to the realization by financial institutions around the world that they were providing billions of cash to other financial institutions in GCF Repo contracts where the underlying security was of negligible or unquantifiable value⁴³ and the assertion of ‘true sale’, given the alleged falsity of value, may have been likewise impossible to give. The private sector gatekeepers of public companies are: lawyers, auditors, analysts, valuers/appraisers, rating agencies, and stock exchanges. Ironically, the Merchant or Investment Bank would ordinarily be considered another gatekeeper, and in some respects the most important gatekeeper⁴⁴ because it is only through a licensed dealer-broker that financial markets can be accessed⁴⁵. The current analysis could therefore be considered a study of the gatekeeper’s gatekeepers.

LEGAL PRACTITIONERS

In the context of 21st Century financial markets, it must be acknowledged that not all lawyers are created equal. It can not reasonably be argued that a court room advocate should do anything but vigorously advocate the position of his client. Neither could it sensibly be argued that a tax lawyer should do anything other than work to minimize his client’s tax bill within the framework of the law. Securities lawyers are different because they perform a

⁴¹ Coffee, John C, Gatekeepers: The Professions and Corporate Governance Oxford University Press at 13

⁴² Ibid. at 46

⁴³ Whitehouse, Tammy, ‘Lehman Examiner Alleges Misleading Conduct’ Compliance Week 12 March 2010

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⁴⁵ Coffee John C, Gatekeepers 2006 Oxford University Press at 200

prescribed role in accessing public financial markets.

In the early part of the 20th Century the American Bar Association included a written prescription of ethical standards at Canon 32, which stated:

“No client, corporate or individual, however powerful, nor any cause, civic or political, however important, is entitled to receive, nor should any lawyer render, any service or advice involving disloyalty to the law, whose ministers we are, or deception or betrayal of the public. The lawyer advances the honor of his profession and the best interest of his client when he renders service or gives advice tending to impress upon the client exact compliance with the strict principles of moral law...”

A nearly contemporaneous statement of US Supreme Court Justice, Louis Brandeis, indicated that the prevailing view was that a lawyer is to hold a position of,

“...independence between ... wealthy [persons] and the people, prepared to curb the excesses of either...”⁴⁶

Justice Brandeis statement of moral principle was not a widely held view and has long since been abandoned by common law jurisdictions in favour of the modern Legal Professions Act, along with Solicitors and Barristers Rules.

Securities lawyers on the other hand continue to be required to play the role of sentinel or gatekeeper of public money and trust. A.A. Sommer, the head of the United States Securities Commission through the 1970's, stated:

“I would suggest that in securities matters the attorney will have to function in a manner more akin to that of auditor than to that of the attorney. This means several things. It means that he will have to exercise a measure of independence that is

⁴⁶ Coffee John C, Gatekeepers 2006 Oxford University Press at 202 quoting Justice Louis Brandeis speech included in The Independence of Lawyers, 68 B.U.L. Rev. I, 2 (1988)

perhaps uncomfortable if he is also the close counselor of management in other matters, often including business decision. It means he will have to be acutely cognizant of this responsibility to the public who engage in securities transaction that would never have come about were it not for his professional presence. It means that he will have to adopt the healthy skepticism toward the representation of management which a good auditor must adopt. It means that he will have to do the same thing the auditor does when confronted with an intransigent client --- resign.”

The UK House of Lords adopted the dissenting judgment of Denning LJ in *Candler v Crane, Christmas & Co* in what is widely regarded as the seminal ‘negligent misstatement’ case in *Hedley Byrne v Heller*. Lord Morris of Borth-y-Gest stated:

“I consider that it follows and that it should now be regarded as settled that if someone possessed of a special skill undertake, quite irrespective of contract, to apply that skill for the assistance of another person who relies upon such skill, a duty of care will arise. The fact that the service is to be given by means of or by the instrumentality of words can make no difference. Furthermore, if in a sphere in which a person is so placed that other could reasonably rely upon his judgment or his skill or upon his ability to make careful inquiry, a person take it upon himself to give information or advice to, or allows his information or advice to be passed on to another person who, as he knows or should know, will place reliance upon it, then a duty of care will arise.

Austin J of the New South Wales Supreme Court recently observed:

“...on the one hand, the common law standard of care emerging from the neighbour principle and the law of negligent misstatement would probably be higher than the old equitable trustee standard of care; while on the other hand, if the duty of care were not an equitable standard, the more restrictive common law rules as to measure of damages, causation and remoteness would

apply in lieu of the equitable principles.⁴⁷

On this point, an academic article, co-authored by Andrew Hughes from Linklaters (ironically I hasten to add) and Nicolas McBride from Oxford University, is helpful.⁴⁸ The authors conclude, based on the House of Lords decision in *White v Jones*, where it was decided that a Solicitor owed a duty to the beneficiary of a will in a circumstance, and where the Solicitor failed to follow instructions from his client and so amend the client's will,⁴⁹ Hughes and McBride argue the Hedley Byrne principle of 'negligent misstatement' is analogous to a breach of fiduciary duty in respect of the beneficiary, and that the Hedley Byrne principle had been inconsistently applied and therefore a shift to a clear fiduciary standard is warranted. It follows that if a securities lawyer were held to have a fiduciary duty to public market or financial market investors, both the burden on the lawyer and the damages that would sound as a result of that breach would be much greater.

The duty of care that is required of a securities lawyer in his performance of due diligence, as an integral part of accessing public financial markets, was first set out in the United States by the South District Court of New York in *Escott v BarChris Construction Co Ltd*.⁵⁰ The Court stopped short of requiring lawyers to conduct a full audit of the companies listing and disclosure documents but did require that securities lawyers 'test information by examining the written record.'⁵¹ It may be helpful at this point to consider the standard that the Court has imposed on auditors in an analogous role. In *United States v Arthur Young & Company*, the court unanimously determined the following:

“By certifying the public reports that collectively depict a corporation's financial status, the independent auditor assumes a public responsibility transcending any employment relationship with the client. The independent public accountant performing this special function owes ultimate allegiance to the corporation's creditors

⁴⁷ ASIC v Rich [2009] NSWSC 1229 p2956 at 7184

⁴⁸ McBride, Nicholas J, Hughes, Andrew Hedley Byrne in the House of Lords: An Interpretation, 1995 Legal Studies 15 at 389

⁴⁹ White v Jones [1995] 1 All ER 691, 694g- 695a (Lord Kieth, 704e-g (Lord Goff), 731j-732c (Lord Mustill)

⁵⁰ 283 F. Supp. At 690

⁵¹ Ibid.

and stockholders, as well as to the investing public. This ‘public watchdog’ function demands that the accountant `maintain total independence from the client at all times and requires complete fidelity to the public trust.”⁵²

It can be seen that the US Supreme Court has imposed a heavy burden on auditors in respect of their function in public financial markets, but as Austin J points out in *ASIC v Rich* and as the Linklaters lawyer (supra.) highlights, the negligent misstatement common law standard is a higher standard of conduct but with a lower monetary consequence. The author will later argue that this is the obverse of what should be the law in respect of public and financial market sentinels and gatekeepers, and lawyers in particular.

The Ontario Court of Appeal permitted investors in a company to pursue a claim against lawyers who had been retained to perform due diligence⁵³ for a public market financing. The Appeal Court Justices were unanimous in their view that the persons raising money (i.e., Promoters) were in a fiduciary relationship with investors and therefore the standard imposed on the lawyers in this context should be higher. The Justices in obiter remarked that, “...although the solicitor was not in a fiduciary relationship with the investors, he stood in a sufficient relationship of proximity with the appellants to “engender a duty of care” on the part of the lawyer.”⁵⁴ The Ontario claim ultimately failed but it was observed that the duty of the lawyer to the company flowed through the company to the shareholders and that included carrying out the lawyers’ “duties of diligence and due care in a reasonably professional and competent manner and with the utmost good faith”.⁵⁵ It is interesting to note that the language of the Ontario Court of Appeal decision is similar to the language employed to describe the duties of Directors in s 180(1) and s 181 of the *Corporations Act 2001* (Cth)

By 1980 the size of financial markets and the need to access ‘market windows’ within those markets resulted in a significant legislative dilution of the standards articulated by A.A. Sommers (supra.) through the introduction of streamlined prospectus which simply made

⁵² *United States v Arthur Young & Company* (1984) 465 U.S. 805

⁵³ *Filipovic v Upshall* [2000] On CA CanLII 5114 at 2

⁵⁴ *Ibid* at 9

⁵⁵ Coffee John C, *Gatekeepers* 2006 Oxford University Press at 205

reference to previously filed 10-K and 10-Q reports.⁵⁶ The question that must be answered is whether a Securities Lawyer is ever in sufficient possession of information to be able to act as a guardian of the public's money, or whether there are circumstances where, as set out in *Hedley Byrne v Heller*, the professional ought to have taken that position, whether it was to his client's liking or not.

OPINION LETTER

In a matter dealing with the use of a legal 'opinion letter' as part of a public market financing, Friendly J. commented that,

“In our complex society the accountant's certificate and the **lawyer's opinion** can be instruments for inflicting pecuniary loss more potent than the chisel or the crowbar.”⁵⁷

(emphasis added)

To give the following analysis of the Linklaters 'True Sale Opinion' context, the author starts by setting out the position of the US Courts where there is a clear judicial rule on the liability of a Securities Lawyer who renders a legal opinion for a publicly traded company. In *Herman & MacLean v Huddleston* it was unanimously held that:

“Lawyers who act as experts in and render expert opinions are reached by s11 of the Securities Act 1933...”⁵⁸

At s11 (4) of the Securities Act 1933 (US) it states:

SEC. 11. (a) In case any part of the registration statement, when such part became effective, contained an untrue statement of a material fact or omitted to

⁵⁶ *United States v. Benjamin*, (1964) 328 F.2d 854, 863 (2d Cir.)

⁵⁷ Selvam Vijay S.V. 'Recharacterisation in "true sale" securitisations: the "substance over form" delusion' J.B.L. 2006, Oct, 637

⁵⁷ *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas at 124

⁵⁸ *Herman & MacLean v Huddleston* (1983) 459 US 375

state a material fact required to be stated therein or necessary to make the statements therein not misleading, any person acquiring such security (unless it is proved that at the time of such acquisition he knew of such untruth or omission) may, either at law or in equity, in any court of competent jurisdiction, sue—

“(4) every accountant, engineer, or appraiser, or any person whose profession gives authority to a statement made by him, who has with his consent been named as having prepared or certified any part of the registration statement, or as having prepared or certified any report or valuation which is used in connection with the registration statement, with respect to the statement in such registration statement, report, or valuation, which purports to have been prepared or certified by him;

This position was affirmed in *Schneider v Traweek* where it was said:

“Opinion Letter writers who allow their opinions to be referenced in registration statements filed under the Securities Act 1933 face personal liability if the opinion includes a material misstatement or omission.”

The Lehman Brothers Examiner’s Report notes that all Repo transactions were automatically treated as loans by Lehman Brothers except the Repo 105 transactions which had to be manually entered as sales:

“Lehman’s electronic accounting systems automatically treated all repo transactions as financing transactions, *i.e.*, borrowings. Since the accounting and trading systems were not designed to treat any repo transactions as sales, a “manual intervention” into Lehman’s electronic books and records systems was necessary to re-characterize Repo 105 borrowings as sales for accounting purposes.”⁵⁹

The Examiner further notes:

⁵⁹ Ibid. at 799

In short, Lehman undertook transactions in a foreign jurisdiction (the United Kingdom) that purported to comply with SFAS 140 [US GAAP], where Lehman was unable to obtain a SFAS 140 true sale opinion from a United States law firm, and Lehman then relied upon the non-United States-based Lehman entity to ensure that the transaction complied with United States GAAP.⁶⁰

In summation the Examiner concludes:

“With a UK legal opinion (i.e., the Linklaters letter) that covered the Repo 105 [108] transactions, Repo transactions would be respected as a **sale in the books** of the entities doing them [but] booking them in US GAAP.” (emphasis added)

In summary, Lehman Brothers moved assets from America to the UK. Lehman Brothers would use the same Global Master Repurchase Agreement that in the United States would result in a liability being added to its Balance Sheet, but on the basis of the ‘true sale’ opinion from Linklaters. Lehman Brothers’ London subsidiary would instead reduce the liabilities and replace the liabilities with cash, namely a ‘current asset’. The London subsidiary would then be consolidated in to Lehman’s Financial Statements in the United States. The exact same transaction that in the US would have resulted in Lehman’s debts swelling by US\$50billion, leaving Lehman almost without ‘net worth’ in Europe was a \$US50billion improvement to the Consolidated Balance Sheet of Lehman Brothers.

There are many unanswered questions about Linklaters role in the Lehman failure, none of which are dealt with in depth in the Examiners Report, except to indicate that none of the previous versions of the Opinion Letter were in the files, and that the Examiner had not contacted Linklaters for comment.⁶¹

⁶⁰ Ibid. at 800

⁶¹ Reinhardt, Uwe E, ‘*Financial Accounting & Decency*’ New York Times 19 March 2010

What can we ascertain from the Linklaters Opinion Letter itself? At paragraph 2.1 of the Linklaters ‘true sale’ opinion letter dated 31 May 2006 it states:

“In determining whether a person has entered into a contract involving the sale of an asset, the courts will look at the substance of the transaction: the terminology used by the parties to the transaction is not necessarily conclusive. Furthermore, if a series of transactions with respect to the same asset are entered into at the same time, it is the substance of the overall arrangements which is important. For example, an arrangement between two parties may purport to involve a sale but on its true analysis actually amount to a charge. Whether this is the case will depend on whether the legal nature of what has been agreed has the characteristics which the law recognises as those of a sale or those of a charge.”

The language employed by Linklaters is taken directly from the decision of Dillon LJ in *Welsh Development* (supra.) Thus one can reasonably infer that Linklaters had done an extensive review of the inconsistencies in UK case law. Determining whether Linklaters facilitated what Anton Valukas, Examiner for the New York Bankruptcy Court has characterized as a ‘colourable or fraudulent’ transaction⁶² by opining that the sale of \$50billion of securities was a ‘true sale’ as opposed to a ‘loan or charge’ may be difficult to attach to Linklaters because of the qualifications attached to the Linklaters’ Opinion Letter, namely:

1. That the opinion was governed by English Law;⁶³
2. That no provisions of foreign law [i.e., US law] would affect the opinion;⁶⁴
3. All voting rights over the assets be transferred to the Buyer;⁶⁵
4. That any income earned on the transferred property is not proprietary;⁶⁶
5. That the Repurchase Agreement is not a ‘sham’;⁶⁷

62 *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas at 227

63 Firth, Smon, Linklaters’ Opinion Letter to Lehman Brothers International Europe, 31 May 2006 at 11

64 *Ibid.* 2, at 1.7(a)

65 *Ibid.* 9. At 3

66 *Ibid.* 11, at 4.2

67 *Ibid.* 9, at 2.6

The second condition of the Linklaters Opinion Letter is vexing. The opinion references a Global Master Repurchase Agreement which is a standard document used for overnight RP contracts and is set by the parent, Lehman Brothers in the United States. It expressly states that it will apply FASB 140, namely US GAAP rules which treat the Repo contract as a loan.⁶⁸ Furthermore, the Repo 105 transaction undertaken by the Lehman London subsidiary continued to show income earned on the securities pledged for the US\$50billion in cash procured from Barclays, Deutsche Bank and others. Thus, although the securities were moved off the Lehman's balance sheet, Lehman Brothers continued to earn the net spread on the pledged securities.

It should be apparent that if there had been a 'true sale' of the assets Lehman Brothers would have earned nothing (\$0.00) on the securities sold.

STATUTORY LIABILITY OF LEGAL EXPERT

In Ontario Canada s 130(1) and s138.1 of the Ontario Securities Act 1990 (Ont) ("OSA") determines that a lawyer acting as an expert may be held liable to buyers of marketable stock in both the primary (i.e., IPO) and secondary markets (i.e., annual or quarterly filings) if the expert report or opinion contains a misrepresentation, material or otherwise, and that misrepresentation is relied upon in its presentation to the public. The use of the misrepresentation can be either written or oral. Thus in Ontario, any investor will be permitted to bring a claim against an expert in respect of any misrepresentation, provided that the claimant can show the following three things:

1. There is a misrepresentation contained in an expert report or opinion letter;
2. The document or oral statement proffered to the public either contains or relies upon the misrepresented expert report or opinion;
3. The expert consented, in writing, to the use of the expert report or opinion letter in the

⁶⁸ *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas at 698

forum that gave rise to reliance on the report or opinion

In the United Kingdom, Schedule 10, s2(1) of the Financial Services and Markets Act 2000 (UK) (“FSMA”) includes similar provisions, albeit currently not as clear:

1. Listing particulars which include or purport to be made in reliance on an expert;
2. The expert statement is included in the listing particulars with the expert’s consent.

The FSMA does not currently include express language about a misstatement but instead relies on the common law for negligent misstatement, namely *Hedley Byrne v Heller* (supra).

In October 2010 an amendment to the FSMA will come into effect that will bring the FSMA in line with the Securities Act 1933 and the OSA, namely The Financial Services and Markets Act 2000 (Liability of Issuers) Regulations 2010. This amendment at new s90A references Schedule 10 and includes an express statement of reliance and liability for misstatement, and in particular in reliance upon an expert, engineer, accountant, valuation person, or other professional.⁶⁹ ‘Other professionals’ would include lawyers.

In the US, in response to a spate of corporate scandals (i.e., Tyco, Global Crossing, WorldCom, Enron, etc.) that cost public market investors US\$480billion⁷⁰, Sarbanes-Oxley introduced changes that put certain clear obligations on Corporate and Securities Lawyers. These obligations are called ‘up-the-ladder’ obligations. Pursuant to s 307 of the Securities Act 1933 Congress enacted new regulations that directed the SEC to issue rules setting out minimum standards of professional conduct for lawyers doing work that is connected to the

⁶⁹ <http://www.publications.parliament.uk/pa/ld200506/ldbills/034/en/06034xab.htm> The introduction of new s90A will give the FSA authority to introduce sweeping transparency and accountability rules, which will have the force of law. The application of these rules will not be tested until after the enactment of 90A in October of 2010.

⁷⁰ Henning, Peter J. ‘Sarbanes–Oxley Act § 307 and Corporate Counsel: Who Better to Prevent Corporate Crime?’ Buffalo Criminal Law Review 2002 Vol. 8: 323 at 324

companies under the purview of the SEC.⁷¹ The SEC sets out certain sentinel or gatekeeper functions as follows:

1. Any regulation shall include rules requiring a lawyer to report evidence of a material violation or breach of fiduciary duty by the company or any agent thereof to the company's Chief Legal Counsel or to the Chief Executive Officer;
2. If neither the Chief Legal Counsel or Chief Executive Officer respond appropriately to the evidence, by taking remedial measures or sanctions, then the lawyer must report the issue to the Audit Committee or another Committee of the Board of Directors comprised solely of person not employed by the public market issuing company.⁷²

While the changes introduced in Sarbanes-Oxley stop short of requiring the securities lawyer to whistle-blow directly to the SEC, it's clear that there is a heavy burden placed on the lawyer to report any issue which may be seen to give rise to a negligent misstatement or to a breach of fiduciary duty. In fact, the language employed stipulates that the lawyer has to continue to push on this matter until the matter has reached non-executive directors, who, one could infer, have do not have the same vested interest in the billion dollar stock option packages that were attributed with the failures of WorldCom, Enron, Global Crossing, Tyco, and the like.

TRUE SALE OR LOAN CHARGE

It must be against the backdrop of § 307 of Sarbanes-Oxley that the second condition of the Linklater's 'true sale' Opinion Letter must be considered. Indeed, many will ask why write the opinion at all, knowing that the burden of disclosure is so high. Linklaters will argue that they indirectly fulfilled this obligation when Ernst and Young reported the Repo 105/108 transactions to Lehman Brothers' Audit Committee.⁷³ The Examiner, however, has concluded that:

71 Snyder, Jeffrey, Regulation of Lawyer Conduct Under Sarbanes-Oxley: Minimizing Law-Firm Liability by Encouraging Adoption of Qualified Legal Compliance Committees, Lawyer Conduct Winter 2005 Vol. 24:1 at 1

71 *Gurfinkel v Bentley Pty Ltd* [1966] HCA 75

71 Ibid. at 2

73 Beresford, Dennis, 'Ernst & Young Response to Audit Committee' re The Auditor, 20 March 2010

“... sufficient evidence exists to support colourable claims against Ernst & Young LLP for professional malpractice arising from Ernst & Young’s failure to follow professional standards of care with respect to communications with Lehman’s Audit Committee, investigation of a whistleblower claim, and audits and reviews of Lehman’s public filings.”⁷⁴

Clearly the conclusion reached by the Bankruptcy Examiner is based on the text of s 307 of Sarbanes-Oxley. Absent the second condition in the Linklaters Opinion Letter abrogating any responsibility for foreign law, namely US law, Linklaters may have difficulty. In fact, as will be shown below, to the extent the Linklaters in the US participated in the Repo 1.5/108 transactions, Linklaters may still be held to the same standard as Ernst & Young.

The law as it relates to the distinction between a ‘true sale’ and a ‘secured loan’ or ‘charge’ or ‘mortgage’ is complex. The decision of the Australian High Court in the case of *Gurfinkel v Bentley Pty Ltd*⁷⁵ was decided by a narrow majority in favour of a mortgage thereby giving rise to a right to an ‘equity of redemption’. The contract documents did not go as far as requiring that the vendor be obligated to repurchase the property, as with RP contracts, but it does illustrate the controversy in characterizing a transaction as a loan rather than as a sale. In the end the High Court decided to look to the substance of the contract to determine the intention of the parties.

In Canada the leading authority on what constitutes a ‘true sale’ as opposed to a ‘secured loan’ is what is referred to as the ‘*Widows and Orphans Fund Case*’, where Ground J in the Ontario Superior Court articulates the two part test for deciding whether a transaction is a ‘true sale’ or a ‘loan agreement’:

“The courts have determined that, where the vendor of an asset has a right of redemption or repurchase at its option, this will be a strong factor in favour of the

⁷⁴ *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas, Volume 3 at 1027

characterization of a receivable transaction as a **secured loan** rather than a true sale transaction. An essential term of a secured loan transaction is the right of the borrower, upon repayment of the debt, to require the lender to reassign to it all of the lender's interests in the assets secured to pay the debt. In the case of a true sale, the vendor has no right to require title to the assets sold to be reassigned to it. In my view, this is the ultimate test to be applied to determine whether a particular transaction should be interpreted as a secured loan or as a true sale.”⁷⁶ (emphasis added)

The Ontario Superior Court found that the question of whether the transaction is a ‘true sale’ or a ‘secured loan’ is in part determined by the gatekeepers:

“The evidence also establishes that, although the directors of BC Tel were aware at the time that the redemption of the Bonds was approved, that there would be an adverse reaction on the part of the Bondholders and that there was a risk of the redemption being challenged by legal action, they proceeded with the redemption based on legal, tax, and accounting advice that the transaction could be legitimately treated as a sale and that any legal challenge to the transaction would, in all probability, be unsuccessful.”⁷⁷

The Ontario Court of Appeal upheld the decision of Ground J and found that the legal opinion characterizing the loan as a ‘true sale’ in a circumstance where Telus (BC Telephones) had a right to repurchase the securities, and an obligation to pay interest (or a fixed redemption sum) did not meet the intention test. In other words, the paperwork said sale, but the intention was clearly a loan, which was in breach of the contract with the Widows and Orphans Pension fund. The Ontario Court of Appeal concluded:

“Given the structure of the Securitization Transaction, it is **sophistry** to suggest that BC

44 *Metropolitan Toronto Police Widows & Orphans Fund v. Telus Communications Inc.* [2003] 168, 30 B.L.R. (3d), at 288

77 *Metropolitan Toronto Police Widows & Orphans Fund v. Telus Communications Inc.* [2003] 168, 30 B.L.R. (3d) 288 at 75

Tel did not bear an "interest cost" in relation to the matter.”⁷⁸ (emphasis added)

It must therefore follow that because Telus (BC Tel) both had an interest cost and a right to repurchase the securities, the Court recharacterized the putative sale as a ‘secured loan’.

By abstraction, one can reason that a contractual obligation to repurchase, which is the case in an RP Contract, is a higher order obligation than an option to repurchase. Thus based on this reasoning, in Canada, one would conclude that a repurchase contract is in fact a ‘secured loan’.

The Canadian decision in the *Widows and Orphans Fund* case was based on the reasoning employed in the UK decision in *Welsh Development Agency v Export Finance Co Ltd*, which principally relied upon decisions in *McEntire v Crossley Brothers Ltd* [1895] A.C. 457; *In re George Inglefield, Limited* [1933] Ch. 1; and, *Chow Yoong Hong v Choong Fah Rubber Manufactory* [1962] A.C. 209.

Welsh Development is authority for the proposition that the intention of the parties is the rebuttable presumption as expressed in the contract documents. Staughton L.J.'s statement in *Welsh Development* (supra.) highlights the difficulty in determining the substance rather than the form of a sale as opposed to a charge (i.e., loan):

“We were referred to a bewildering array of authority on this topic, some of it by no means easy to reconcile. The problem is not made any easier by the variety of language that has been used: substance, truth, reality, genuine, [all] good words; disguise, cloak, mask, colourable device, label, form, artificial, sham, stratagem and pretence are ‘bad names’...”⁷⁹

Further, Dillon L.J. citing Romer LJ in the *George Inglefield* case, stated that there was no

⁷⁸ *Telus Communications Inc. v Metropolitan Toronto Police Widows & Orphans Fund* [2005] 5 B.L.R. (4th) 251 at (Telus sought leave for appeal from the Supreme Court of Canada and was denied)

⁷⁸ *Welsh Development Agency v Export Finance Co Ltd* [1992] B.C.C. 270 at 300

⁷⁹ *Welsh Development Agency v Export Finance Co Ltd* [1992] B.C.C. 270 at 262

single transparent test by which the matter could be determined.⁸⁰ However, in *George Inglefield* it was stated that the courts have always claimed to adopt a “substance over form” approach:

“The only question that we have to determine is whether, looking at the matter as one of substance, and not of form, the discount company has financed the dealers in this case by means of a transaction of mortgage and charge, or by means of a transaction of sale...”⁸¹

In *Welsh Development* Dillon L.J. also relied on the decision in *Lloyds & Scottish*, where Lord Wilberforce states:

“...it would be a strange doctrine of ‘looking for the substance’ or ‘looking through the documents’ which would produce a contractual intention so clearly negated by the documents...”⁸²

Lord Wilberforce is buttressed with the incisive observation of Lord Templeton where he points out that the function of the device should trump the label or rubric attached thereto:

“...the manufacture of a five-pronged implement for manual digging results in a fork even if the manufacturer, unfamiliar with the English language, insists that he intended to make and has made a spade”.⁸³

On the other hand, Staughton LJ, found that there are four indicia or badges of a transaction that is a loan and not a sale. He describes these as:

“... (i) price, (ii) discount, (iii) right of redemption, and (iv) right of retention.

80 In re *George Inglefield Ltd* [1933] Ch. 1 27 at 280

81 Ibid.

82 *Lloyds & Scottish* [1979] 129 N.L.J. 366 at 372

83 *Street v Mountford* [1985] A.C. 809 at 819

[These] are described as badges, or indicia, of a loan transaction.”⁸⁴

Gibson LJ, in the *Welsh Development* decision describes the Exfin ‘Master Financing’ documents as being capable of differing interpretations:

“a most skillfully drawn lawyer's document ... designed ... to cast in the mould of agency and sale an agreement which, in commercial terms, is a financing agreement equally capable of being explained as one by way of secured loan.”⁸⁵

Unfortunately, unlike the principled analysis that was employed by the Ontario Superior Court and the Ontario Court of Appeal, the decision in *Welsh Development* Dillon LJ concludes that “the crux” of the parties' intention⁸⁶ may in part be evidenced by the labels chosen by the contracting parties, notwithstanding the intention of the transaction which is to be found in its effect.

In *Welsh Development* all three law Lords accepted the substance over form rule but only Staughton LJ set out clear indicia for distinguishing a ‘sale’ from a ‘loan or charge’. The ambiguity in UK case law is summarized in an academic review of the case law, where Professor Selvam notes:

“... legal certainty as to what exactly will constitute a clean sale of the receivables, free from any risk of recharacterisation, is of immense importance at the time of documenting the transaction. Unfortunately, English case law on this point is ambiguous, uncertain and riddled with inconsistencies.”⁸⁷

This may be a reason why Lehman Brothers was able to obtain a ‘true sale’ legal opinion in the

84 *Welsh Development Agency v Export Finance Co Ltd* [1992] B.C.C. 270 at 281

85 *Ibid.* at 204

86 *Ibid.* at 300

87 Selvam Vijay S.V. ‘Recharacterisation in "true sale" securitisations: the "substance over form" delusion’ J.B.L. 2006, Oct, at 638

74 *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas, Volume 3 at 798, 799

United Kingdom when none was available from an American law firm.⁸⁸ The author is fond of saying “you can dress a pig up in feathers but that doesn’t make it a peacock”. The ‘true sale’ opinion letter issued by Linklaters, because of ambiguity in the case law and because of the broad nature of the qualifying conditions, is just such a pig.

For the sake of completeness, the author will quickly review what constitutes a ‘true sale’ under US law. Firstly, the categorization of a document in the US is determined solely by the legal or commercial effect that it is intended to create. In the *Enron* case, the same two part test as was decided in the *Widows and Orphans* case (supra.) was employed, where Berg J states that interpretation of the contract document:

“...clearly demonstrates a two-stage analysis: (a) ascertaining the “substance” of the document from its “language”; and (b) categorising the document based on its legal effects. Thus the contractual terminology of the parties evidenced in the language of the documents yields a rebuttable presumption of categorisation in favour of this expressed intention. This presumption may be rebutted by demonstrating that the “legal effect” of the transaction is inconsistent with the language used by the parties. In such circumstances, the “ill-chosen” language is to be disregarded and the transaction recharacterised in accordance with its “legal effect”.⁸⁹

The courts enquire into various factors, such as the identity of the party who bears the risk of loss in the transaction.⁹⁰ The intention of the parties is considered as a factor to be considered in a judicial determination.⁹¹ It does not, however, occupy the position of a rebuttable presumption as it does in England and Wales.

1. This statement suggests that “substance” determines “contractual intention”, which, in turn, determines the question of recharacterisation.
2. Ultimate test to be applied to determine whether particular transaction is secured loan

89 Re Enron [2003] J.B.L. 205 per Berg J at p.218

90 *Endico Potatoes Inc v CIT Group/Factoring Inc*, 67 F.3d 1063, 1069 (2d Cir. 1995); *Golden Plan*, 829 F.2d at 709-710; *Major Furniture Mart*, 602 F.2d at 545; *LTV Steel ABS Opinion in its Proper Context*,

91 *Joseph Kanner Hat Co, Re* 482 F.2d 937 (2d Cir. 1973)

or true sale is right of borrower, upon repayment of debt, to require lender to reassign to it all of lender's interest in assets secured to pay debt — In case of true sale, vendor has **no right** to require title to assets sold to be reassigned to it.⁹²

In summary, it is difficult to find a large body of case law outside the United States where lawyers have been held to the same standard of care and responsibility as the Directors and Officers of the company. As a general principle this must be right because lawyers are, even in the more rigorous legislative environments in the United States and Canada, are meant to protect the confidential information of their client and to report misdeeds to the appropriate Directors. There are a couple significant and notable exceptions. The first is *The Crown v Shead*, where a lawyer was held liable for several counts of fraud for making negligent disclosures to investors. In analyzing one of the allegations against the securities lawyer, Krindle J. of the Manitoba Court of Queen's Bench held: :

“Mr. Shead possessed the requisite knowledge of all the relevant facts and that he, possessing that knowledge, aided the client in the commission of the crime by preparing and executing the documentation. He thereby becomes a party to the offence of fraud. Without that knowledge, he would not have become a party”.⁹³

In the United States, in the wake of the Savings and Loan scandal, the US government recovered US\$1.7billion from professional advisors, most of that coming from audit firms. The most notable claim against securities lawyers was that of Kay, Scholer, Fierman, Hays, & Handler, the lawyers for Charles Keatings, Lincoln Savings and Loan.⁹⁴

In the United States it has been held that a lawyer is unable to prevent a corporate client from engaging in a dishonest act, and is therefore not liable, unless the dishonest act is reliant upon an action of the lawyer. This is the case when the lawyer provides expert reports including opinion letters which are used in the course of 10-K or 10-Q filings, or any secondary filing.

One must consider that in the case of Lehman Brothers, access to repurchase lines was inexorably linked

92 *Woodson Co*, 813 F.d at 272

93 *R v Shead* [1996] M.J. No. 466 (Q.B.)

94 Coffee, *John Gatekeepers* Oxford University Press 2000 at 213

to FASB 140 quarterly audit filings with the SEC. In late 2007 and up to September 2008 Lehman Brothers relied on these filings in the course of raising approximately US\$12billion of fresh equity.⁹⁵ These are large sums that would likely have involved both Linklaters and Wail Gotschal Menges, Lehman's primary global counsel. Will the language of the Linklaters' opinion letter ultimately shield the law firm from the same law claims as Ernst & Young? Only time can answer this question.

The purpose of the foregoing analysis was to point out that had Linklaters looked to US or Canadian law, they could not have issued a 'true sale' opinion letter, but rather would have concluded that all RP transactions are in fact secured loans, not dissimilar to a Bill of Sale transaction. The analysis also shows that the standard of conduct for a legal practitioner who issues an expert opinion letter, in the United States is much higher than in the UK. This has resulted in American securities lawyers being held to account alongside their clients. While I can find no evidence of similar results in the UK or Australia, the changes in law that are an inevitable consequence of the damage caused by the Lehman Brothers' failure will doubtless percolate for western public markets for years to come.

Sarbanes-Oxley was the response to investor losses totaling less than US\$0.5 trillion as result of accounting frauds in the nineties, including Tyco, Enron, WorldCom, Parmalat, HHH, Nortel, and other corporations of that ilk,. The losses suffered by market investors as a result of over-zealous Savings and Loan lenders in the eighties were less than US\$100 billion. The losses from the recent global financial crisis are yet to be fully counted but must measure in the trillions of dollars when all investor losses are added to the public monies that have been required to shore up the balance sheets of financial institutions worldwide.

This then leaves the question, what changes should be implemented to make legal professionals the 'wise counselors' conceived by Justice Brandeis?

REMEDY THE PROBLEM

As financial markets move further from principle based governance and increasingly toward rule based governance, lawyers play an increasingly important role in navigating financial regulation. It has been said that lawyers serve as "critical facilitators" for their clients⁹⁶. It

⁹⁵ *In re Lehman Brothers Holdings Inc* [2010] US Bankruptcy Court, Southern District of New York 08-13555 JMP per Examiner Anton Valukas, Volume 1 at 23

⁹⁶ *Filipovic v Upshall* [2000] On CA CanLII 5114 at 8

should be apparent that lawyers can detect and potentially disrupt the wrongful conduct of client companies in the context of their dealings with financial markets. The ongoing nature of the relationship, and the high cost to both parties of ending it, has the potential to constitute lawyers as particularly effective gatekeepers. Lawyers can and do collect information from their clients that would be difficult or impossible for regulators to collect on their own. Lawyers are also in a position to advise clients about both the letter and the spirit of the law.⁹⁷

However, the relationship necessary to create liability in tort for negligent or fraudulent misrepresentation or for breach of the fiduciary duty of care is difficult for investors to establish. Furthermore, once established, the courts are relatively unlikely to find negligence or breach of duty of care giving rise to damages. For example, in the case of *Dupuis v. Pan American Mines*¹⁰⁶ the corporation's lawyer had prepared a prospectus containing a false statement that the defendant owned certain mining properties, but the lawyer had relied on another lawyer and was therefore not held to account.

Outside the United States, how do we ensure that lawyers are held to account for their part in transactions which ultimately cost the investing public millions and in the case of Lehman Brothers, billions of dollars.

JURISDICTION SHOPPING

Avoidance of the law is an acceptable arrangement of connecting factors for a legitimate purpose, for example in an agreement, usually between two equal bargaining parties, in order to select an appropriate applicable law or jurisdiction.⁹⁸ There is a principle in the conflict of laws, better known in civilian jurisdictions under the French name "*fraude à la loi*" or the German name, "*Rechtswidrige Umgehung eines Gesetzes*", which is comprised of deliberate and improper manipulation of contacts (connecting factors), in order to avoid the application of

⁹⁷ *Dupuis v Pan American Mines* (1979), 7 B.L.R. 288 (Qué. S.C.)

⁹⁸ Tetley, William Dr. *International Conflict of Laws*, 1994 at pp. 135-172.

the proper law, where ‘proper law’ is defined as the law with the most clear nexus to the subject matter of the contract.⁹⁹

In maritime law it has long been accepted that a shipowner should not be permitted to shop for a flag that is used for the purpose of avoiding the laws of the parent company. While this was at one time considered avoidance of the law, today it is deemed to be an evasion of the law.¹⁰⁰

By analogy it should be clear that the reporting and disclosure standards imposed on a securities lawyer should rise to the highest standard in the reporting chain. Lehmans relied on the weakness in the law in the United Kingdom, and while this may change with the new rules that are expected to be promulgated by the United Kingdom’s Financial Services Authority following s 90A (supra.) coming in to force later this year, the author submits that this is not adequate protection for public financial market investors.

It seems clear that for global public companies, and in particular those that themselves serve a gatekeeping function, namely Merchant/Investment Banks, as with international shipowners, there should be an absolute prohibition on jurisdiction/flag shopping. This could be achieved legislatively or by an amendment to Basel2 under the auspices of the signatories of the International Security Market Association (“ISMA”). It seems relatively straight forward for ISMA members to agree that signatories will abide by the highest standard (not the lowest) under applicable law for the directors, officers, and professional gatekeepers of all of its members.

WITHDRAWAL

As a general proposition, a lawyer is obligated to withdraw as counsel if instructed by the client to do something inconsistent with the lawyer's professional responsibility, including the duty to the court. In some jurisdictions, if the legal practitioner is aware of a ‘colourable’ or ‘fraudulent’ transaction, withdrawal is mandatory if the client persists against the instruction

99 Ibid. at 134

100 Article 92 (1) of the *United Nations Convention on the Law of the Sea*, 1982; Tetley, William Dr., "The Law of the Flag: 'Flag Shopping' and Choice of Law" (1993) 17 *The Maritime Lawyer*, 139-184; Tetley, *Int'l. C. of L.*, 1994 at p. 158-159.

of the lawyer. A continued relationship by the lawyer would be a breach of ethics. For a securities lawyer, withdrawal means clear refusal by the practitioner to implement the client's instructions, and a general refusal to continue to advise the company absent a change of course by the directors or officers of the company. A lawyer must not advise or assist a client to commit a crime or fraud. The obligation to withdraw should be codified for all counsel to merchant banks with assets exceeding US\$1.0billion. There should be a commissioner for receipt of withdrawal notices established by the regulators in all jurisdictions where public investment funds are regularly accessed.

DISCLOSURE

A system for whistle-blowing should be devised which extends beyond extends beyond the Audit Committee or the Non-Executive Directors, to a Legal Compliance Committee. comprised of barristers with no connection to the merchant bank, preferably from geographic areas that are not connected to the banking industry. The committee would be under a legal obligation to file a withdrawal notice with the FDIC or the SEC or FSA or APRA or ASIC, thereby putting regulators on notice of an issue without breaching any rules of professional privilege.

NO REVOLVING DOORS

Hank Paulson went from acting as Chairman and CEO of Goldman Sachs to acting as Treasury Secretary to George W. Bush. John Douglas went from the FDIC to being a partner at the international law firm, Davis Polk, where primary client is Citigroup in respect of FDIC matters". John C. Murphy went from the FDIC to being a partner at Cleary Gottlieb; and Kevin Stein went from the FDIC to FBR Capital Markets. The Lehman Brothers Examiner, observed that the accounting department of Lehman Brothers was largely staffed by former Ernst & Young employees. It has been widely publicized that ratings employees were induced by the prospect of a significantly better paying investment banking job.¹⁰¹

101 <http://www.opensecrets.org/revolving/top.php?display=F> 'Revolving Door: Top Lobbying Firms' January 2010

No gatekeeper should be permitted to take employment, directly or indirectly, with a merchant banking client for a period of not less than 3 years from the date of ceasing to be employed by the gatekeeper firm or company.

IN-HOUSE COUNSEL

The head of in-house legal for Lehman Brothers would have had the same level of knowledge as that of the Directors and Officers, but had the added advantage of understanding the holes in legislative prohibitions to bad behavior. The Examiner in Lehman Brothers notes that certain legal working papers were not available but it is difficult to imagine that the legal department didn't work overtime to effect a quarterly transfer of US\$50billion of securities from the United States to Europe and the additional work that was required to prepare the securities for attachment to the Global Master Repurchase Agreement in order to accommodate such a large volume of Repo 105/108 cash infusing transactions. The author has no evidence on this but has come to the conclusion based on experience and inference from the Lehman Brothers Examiners Report

To wit, in house counsel for merchant banks should be included with Directors and Officers as being held to the same standard of care and utmost good faith.

CONCLUSION

There is considerable evidence that Repo 105/108 repurchase contracts were 'shams' that were expressly undertaken in a way that would substantially change the complexion of the Lehman Brothers balance sheet. There is no evidence that Lehman Brothers could not have used its liquid securities to raise substantial sums of cash in the United States, but the evidence shows that Lehman's would have been required under FASB 140 and US securities law to book these repurchase transactions as 'charges' or 'secured loans' which would have added US\$50billion to their total debt. The analysis shows that it is likely that the repurchase contracts would be recharacterized as 'secured loans' under Canadian, Australian, US, and indeed, UK law.

It is beyond question that booking US\$50billion in additional debt would have put Lehman's well outside the legislative restrictions, such as reserve ratio, liquidity ratio, required of a US based investment bank.

Change is required. Sarbanes-Oxley raised the bar for auditors and the focus of most litigation in the wake of the Lehman Brothers Examiners report will doubtless involve the Lehman auditor, Ernst & Young. The author submits that the net should be widened to include all gatekeepers with particular focus on legal practitioners because lawyers are in the best position to assist in the evasion of the 'good faith' obligations of a merchant bank and should therefore bear the highest burden of protecting the public from 'shams transactions'.

B. Hansen JD (Hons)

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31 May 2006

Dear Sirs

Repurchase Transactions under a Global Master Repurchase Agreement

1 Introduction

1.1 You have asked us to review the Global Master Repurchase Agreement ("GMRA") that you intend to use for repos or reverse repos and buy/sell backs of securities and financial instruments ("Securities") with various counterparties. References to the GMRA in this opinion are to both the 1995

²⁹ Letter from Linklaters, to Lehman Brothers International (Europe), re: Repurchase Transactions under a Global Master Repurchase Agreement (May 31, 2006) [LBEX-LBIE 000001]. Lehman's internal Repo 105/108 Accounting Policy and an internal PowerPoint presentation referenced several iterations of the Linklaters opinion letter and witnesses state that Lehman refreshed the Linklaters letter on more than one occasion. *See* Lehman, Global Balance Sheet Overview of Repo 105 (FID)/108 (Equities) (July 2006), at p. 3 [LBEX-WGM 748489] (stating that true sale opinion letter for GMRA was first obtained in May 2001, updated in September 2004, and further updated in May 2006); Lehman Brothers Holdings Inc., Accounting Policy Manual Repo 105 and Repo 108 (Sept. 9, 2006), at p. 1 [LBEX-DOCID 3213293] (stating that Linklaters has issued opinions under a GMRA); *see also* Examiner's Interview of Anuraj Bismal, Sept. 16, 2009, at p. 8 (stating that Edward Grieb refreshed the Linklaters letter). Though Lehman refreshed the letter several times, the Examiner has been able to locate only one version of the Linklaters letter, dated May 31, 2006.

version and the 2000 version of the GMRA: the analysis in relation to each of them is the same.

1.2 For the purposes of this opinion, we have examined a copy of the GMRA but no other documents. Terms defined in the GMRA have the same meanings in this opinion.

13 Under the GMRA, the parties thereto may enter into transactions for Securities ("**Transactions**") in which one party, as Seller, agrees to sell Securities (the "**Purchased Securities**") to the other party as Buyer, against the payment of a price (the "**Purchase Price**") for the Purchased Securities to Seller.

1.4 At the same time, the parties enter into an agreement under which Buyer will sell to Seller Securities equivalent to the Purchased Securities (the "**Equivalent Securities**") at a certain date or on demand against payment of a price (the "**Repurchase Price**") by Seller to Buyer.

15 The purpose of this opinion is to advise you about whether the transfer of the Purchased Securities to the Buyer for the Purchase Price may, under English law, be classified as a sale involving the disposition of the Seller's entire proprietary interest in the Purchased Securities, as opposed to a charge.

16 This opinion is limited to English law as applied by the English courts and is given on the basis that it will be governed by and construed in accordance with English law.

1.7 For the purpose of this opinion we have assumed that:

- (a) there are no provisions of foreign law which would affect this opinion;
- (b) the GMRA and each of the Transactions is within the capacity and powers of each of the parties to it, will be validly executed and delivered by those parties and is valid, binding and enforceable under English law;
- (c) at the time of each Transaction each of the assets comprising the Purchased Securities are beneficially owned by Seller at the time of its transfer to Buyer; and
- (d) the Purchased Securities consist of liquid securities, so that the Buyer could easily dispose of the Purchased Securities and acquire equivalent securities if it wished.

2 Reclassification of the transaction

21 General

Generally speaking, the English courts recognise both the freedom of the owner of an asset to transfer his interest in that asset to another person and the freedom of the parties to a contract to determine the nature of the interest that is to be transferred. Whether a contract involves the sale of the owner's entire interest in the asset or the transfer of some lesser interest, such as a charge, is primarily determined by construing the terms of the contract.

In determining whether a person has entered into a contract involving the sale of an asset, the courts will look at the substance of the transaction: the terminology used by the parties to the transaction is not necessarily conclusive. Furthermore, if a series of transactions with respect to the same asset are entered into at the same time, it is the substance of the overall arrangements which is important. For example, an arrangement between two parties may purport to involve a sale but on its true analysis actually amount to a charge. Whether this is the case will depend on whether the legal nature of what has been agreed has the characteristics which the law recognises as those of a sale or those of a charge.

In the present case, we understand that the Purchased Securities will be transferred to Buyer pursuant to the GMRA. Usually the courts look only to the documentation pursuant to which assets have been transferred to determine whether the parties intended such a transfer to be a sale (albeit that such documentation may be construed in the light of any relevant background material). Accordingly, provided that the documentation recording the transfer of the Purchased Securities to Buyer is consistent with the parties' intentions that Seller should have disposed of its entire proprietary interest in the Purchased Securities to the Buyer, that would, in our opinion, evidence a sale rather than a charge. However, a court would look at the overall arrangements to determine whether a transfer should be classified as a sale or as a charge where it is alleged either that the terms of the documentation by which the assets were transferred had been supplemented or modified by provisions in other documentation or else that the sale documentation was a "sham" (see paragraph 2.5 below).

Consequently, it is necessary to consider, with respect to any Transaction, whether the arrangements for Buyer to transfer to Seller or its agent Equivalent Securities against the payment of the Repurchase Price by Seller (less any dividends, interest or other distributions of any kind paid in respect of the Purchased Securities ("**Income**")) then payable and unpaid by Buyer to

Seller), would mean that the arrangements pursuant to which the Purchased Securities were transferred to Buyer would be construed as a charge. If so, Seller would retain a proprietary interest in the Purchased Securities and would not have effected a sale of them. It is also necessary to consider whether the Buyer's agreement to transfer any Income to Seller indicates that Seller has not disposed of its entire proprietary interest in the Purchased Securities.

2.2 The distinction between a sale and a charge

In our opinion, one of the essential characteristics of a sale of an asset is that the seller intends to transfer outright to the buyer his entire proprietary interest in the asset. Conversely, one of the essential characteristics of a charge is that, despite any transfer of assets between the parties, they intend the person creating the charge to retain a proprietary interest in the property which is the subject of the charge, so that on the discharge of his obligations he is entitled to the return of that property from the chargee. In other words, the chargor has not transferred outright to the chargee his entire proprietary interest in the assets transferred but has retained such an interest as allows him to demand the return of those assets on the discharge of his obligations.

Assets may be transferred to a transferee under an arrangement whereby such assets will or may be transferred by the transferee at a later date back to the transferor. However, if, in such a situation, the transferor is merely entitled to the delivery of *equivalent assets* (such as securities of the same series and nominal value) rather than the very assets that were originally delivered, this is, in our opinion, inconsistent with the existence of a charge because the transferor does not intend to retain a proprietary interest in the assets originally delivered. The only exception to this is where the transferee is to hold the assets on a fungible basis, together with other property of the same type, and the intention is to return a proportionate share of the pool of property that is held in this way. In the present case, however, there is no evidence of any such intention in the GMRA. The mere fact that the securities which are to be delivered have the same CUSIP numbers as the ones that the transferee originally received would not prevent them from being regarded as equivalent assets rather than the very assets that were originally delivered.

2.3 The effect of the transfer of Equivalent Securities

2.3.1 Transfer to Seller of equivalent assets and the option of cash settlement in the event of redemption of the Purchased Securities

Paragraph 3(f) of the GMRA provides that Buyer shall transfer Equivalent Securities to Seller (i.e., Securities which are equivalent to, and not necessarily the same as, the Securities comprising the Purchased Securities, or, if and to the extent that the Purchased Securities have been redeemed, by paying a cash sum equivalent to the proceeds of the redemption). Moreover, Buyer is not required to hold the Purchased Securities separately from its own assets and nothing in the GMRA expressly restricts Buyer's right to deal with the Purchased Securities. This makes it clear that the parties do not intend Seller to have the right to require the return of the particular Purchased Securities transferred to Buyer in any Transaction or, therefore, to retain any proprietary interest in the Purchased Securities. In our opinion, therefore, and subject to the points made below, the transfer of Purchased Securities under any Transaction would be construed as a sale rather than a charge.

2.3.2 Substitution

Paragraph 8 of the GMRA states that, if Seller requests and Buyer so agrees, a Transaction may be varied by the transfer by Buyer to Seller of Securities equivalent to the Purchased Securities (or of such of the Purchased Securities as shall be agreed) in exchange for the transfer by Seller to Buyer of other Securities of such amount and description as shall be agreed ("**New Purchased Securities**").

In our opinion, the variation of any Transaction by Seller transferring the New Purchased Securities to Buyer in return for Securities equivalent to the Purchased Securities does not affect the analysis that the original transfer of Purchased Securities would be construed as involving a sale rather than a charge. Again, Seller's right is to Equivalent Securities not the Purchased Securities. Likewise, provided that Seller's transfer of New Purchased Securities to Buyer under paragraph 8 of the GMRA is, and is intended to be, subject to the same arrangements applying to the purchase of the Purchased Securities under the GMRA, we believe that such transfer would also be regarded as involving a sale of the New Purchased Securities by Seller rather than a charge. This is not affected simply because the

consideration received by Seller in return for making that transfer may be itself the transfer of Equivalent Securities by Buyer.

2.3.3 Margin Payments

With respect to any transaction under the GMRA, at any time from the date of the purchase of the Purchased Securities (the “**Purchase Date**”) to the date of the purchase of the Equivalent Securities (the “**Repurchase Date**”) (or, if later, the date of the delivery of the Equivalent Securities to Seller or the date of the termination of the Transaction), each party is entitled to calculate its exposure under that Transaction (the “**Transaction Exposure**”). The Transaction Exposure is the difference between (i) the Repurchase Price multiplied by the applicable Margin Ratio (subject to recalculation where the Transaction relates to Securities of more than one description to which different Margin Ratios apply) and (ii) the Market Value of Equivalent Securities at such time. Buyer will have a Transaction Exposure if the value of (i) is greater than the value of (ii) and Seller will have a Transaction Exposure if the value of (ii) is greater than the value of (i).

Paragraph 4 of the GMRA provides that if at any time a party has a Net Exposure in respect of the other party, it may by notice require the other party to make a transfer to it of an aggregate amount or value at least equal to that Net Exposure (a “**Margin Transfer**”). There will be a Net Exposure if the aggregate of all of the first party’s Transaction Exposures (plus any unpaid Income Payments due to it but less the amount of Net Margin provided to it) exceeds the aggregate of all the other party’s Transaction Exposures (plus any unpaid Income Payments due to it but less the amount of Net Margin provided to it).

Subject to paragraph 4(d), when a party has a Net Exposure and requires the other party to pay a Margin Transfer to it, the Margin Transfer may be satisfied by the payment (or repayment) of Cash Margin or the delivery of Margin Securities (or Equivalent Margin Securities). Because the above arrangements do not give Seller any right to the Purchased Securities, they do not affect our opinion that the transfer of the Purchased Securities under any Transaction would be construed as involving a sale rather than a charge.

Paragraph 4 of the GMRA, however, further provides that Net Exposure may be eliminated by the repricing of Transactions or the adjustment of Transactions, or a combination of these methods.

If a Transaction is *repriced*, the Original Transaction is terminated and the parties enter into a new Transaction (the “**Repriced Transaction**”). Purchased Securities under the Repriced Transaction are Securities equivalent to the Purchased Securities under the Original Transaction. The obligations of the parties with respect to the delivery of Purchased Securities and the payment of the Purchase Price under the Repriced Transaction are set off against their obligations with respect to the delivery of Equivalent Securities and the payment of the Repurchase Price under the Original Transaction and, accordingly, only a net cash sum is paid by one party to the other.

If a Transaction is *adjusted*, the Original Transaction is terminated and the parties enter into a new Transaction (the “**Replacement Transaction**”), under which the Purchased Securities are Securities agreed between the parties, the Market Value of which is substantially equal to the Repurchase Price under the Original Transaction. The other terms of the Replacement Transaction are as agreed between the parties. Assuming that under the Replacement Transaction the parties agree that Buyer shall transfer Equivalent Securities against payment of the Repurchase Price as per the provisions of GMRA, we would restate our opinion in paragraph 2.3.1 above.

Accordingly, we do not believe that these provisions affect our conclusion that the transfer of the Purchased Securities under the Original Transaction would be construed as involving a sale rather than a charge.

2.4 The effect of the arrangements regarding Income

Paragraph 5 of the GMRA provides that Buyer will pay to Seller an amount equal to any Income which is paid in respect of the Purchased Securities in the specified period. In certain circumstances, a transfer of assets coupled with the retention of the right to receive the income on the assets could be construed as involving the retention of a proprietary interest in or relating to the assets, i.e. a transfer of title subject to the reservation that the rights to income are to be held on trust for the transferor. Alternatively, an

undertaking to pay income on the assets could be construed as involving an implied restriction on the transferee's freedom to deal with the assets.

In the present case, however, paragraph 5 of the GMRA makes it clear that Buyer's obligation in this respect is simply an obligation to pay an amount which is equivalent to any Income paid in respect of the Purchased Securities (there being, under the GMRA, no obligation to hold such Income in a separate account or any other indication that a trust over it and/or the right to receive it is intended).

As a result, we do not think that the arrangements regarding the payment of any amounts equivalent to Income to Seller would be construed as involving the retention by Seller of a proprietary interest in the Purchased Securities. Accordingly, they do not affect the conclusion that, in our opinion, the transfer of the Purchased Securities to Buyer would be construed as involving a sale rather than a charge.

2.5 The effect of the arrangements regarding voting

The GMRA contains no provisions regarding voting rights. Accordingly, any voting rights attached to the Purchased Securities the record date for which is after they are transferred to the Buyer will pass to the Buyer. This is consistent with our conclusion that the transfer would be construed as involving a sale rather than a charge.

The position is slightly different under the Equities Annex to the GMRA (2000 version) (the "**Equities Annex**"), which contains certain supplementary terms and conditions for transactions in equities. Paragraph 4(b) of the Equities Annex provides that, where voting rights fall to be exercised in relation to any Purchased Securities which are equities and in respect of which Equivalent Securities have not been transferred, the Buyer shall use its best endeavours to arrange for voting rights of that kind to be exercised in relation to the relevant number of securities of that kind in accordance with the Seller's instructions.

If a provision entitling the Seller to direct how the votes attached to the Purchased Securities must be exercised were construed as imposing an obligation on the Buyer to continue to hold the Purchased Securities, such a provision might call into question whether the Seller had agreed to transfer its entire proprietary interest in the Purchased Securities to the Buyer. The courts might conclude that the substance of the arrangements in such a case was that the Buyer had agreed to hold the Purchased Securities during the term of the transaction and, notwithstanding the references to Equivalent

Securities, the true agreement was that the Buyer had agreed to redeliver the Purchased Securities on the termination of the transaction. This might, in turn, lead to the conclusion that the arrangements were intended to involve no more than a charge granted by the Seller over the Purchased Securities in favour of the Buyer. Alternatively, the GMRA might be construed as imposing a trust over the voting rights in favour of the Seller.

Paragraph 4(b) of the Equities Annex, however, provides that the Seller's right to give instructions regarding the exercise of voting rights applies only if the Buyer is holding the Purchased Securities. The Equities Annex cannot, therefore, be construed as imposing an express or implied obligation on the Buyer to continue to hold the Purchased Securities, or as constituting a trust over the voting rights in favour of the Seller. Accordingly, this does not affect our conclusion that the GMRA involves a sale of the Purchased Securities, even if they include equities and the Equities Annex is used.

2.6 Sham transactions

In coming to the conclusions set out in this opinion, we have assumed that the GMRA accurately reflects the agreement between the parties. If it is merely a "sham", i.e. the common intention of the parties is not to create the legal rights and obligations which the GMRA has the appearance of creating, then extrinsic evidence may be adduced to enable the courts to discover what was actually agreed. For example, if the parties' common intention is that the Buyer will not transfer Equivalent Securities on the Repurchase Date, but this provision has been included to make the transfer of the Purchased Securities by Seller look like it involves a sale, the courts will ignore such provision in determining whether the transfer actually did involve a sale or not.

Similarly, if the parties subsequently enter into an agreement (orally, in writing or by conduct) which is inconsistent with the GMRA, the courts may decide that they have agreed to vary the terms of the GMRA. We have therefore assumed that no such agreement has been or will be entered into.

3 Transfer of ownership

The steps that are required to be taken to transfer assets from one person to another are determined by reference to the laws of the jurisdiction in which the assets are regarded in law as being situated (the *lex situs* of the assets). Hence, even if, as a matter of English law, Seller would be regarded as having sold the Purchased Securities to Buyer (i.e. as having *agreed* to transfer its entire proprietary interest in the Purchased Securities to Buyer), whether Seller's entire proprietary interest has in fact been transferred pursuant to the GMRA is a

matter for the *lex situs* of the Purchased Securities. In other words, the mere entry into of the GMRA (or any Transactions under it) will not be sufficient to transfer title to the Purchased Securities. The Purchased Securities must actually be transferred pursuant to the GMRA. The steps that need to be taken to achieve this will be a matter for the *lex situs*. Where title to the Purchased Securities is evidenced by entries in a register or account maintained by or on behalf of an intermediary and Regulation 19 of the Financial Collateral Arrangements (No.2) Regulations 2003 applies, this will be the law of the country in which the account is maintained.

Furthermore the nature of Buyer's interest in the Purchased Securities will depend on the nature of the assets constituting the Purchased Securities and the way in which such are held by Buyer. In other words, that interest may not be a proprietary interest. For example, if as provided by paragraph 6(a) of the GMRA, delivery of the Purchased Securities takes place by book entry transfer through Euroclear, Clearstream or an agreed securities clearing system, this may not involve the transfer of a proprietary interest in any securities held in such system but merely an adjustment to the contractual (or other) obligations between the system (or its operator) and the person through which the Purchased Securities are held by Buyer in the system (ie the asset in question could be contractual rights in respect of the Purchased Securities, rather than the Purchased Securities themselves). However, in each case, provided that Seller transfers to Buyer all the rights and interests it may have in or in relation to the Purchased Securities, retaining no enforceable interests, and intending to transfer its entire proprietary interest, then in our opinion, the transfer would properly be considered a sale as opposed to a charge.

4 The creation of a fresh proprietary interest

Even if the arrangements between Seller and Buyer for the transfer of the Purchased Securities would be construed as a sale and, hence, an agreement to transfer Seller's entire proprietary interest in the Purchased Securities, it also needs to be considered whether, in respect of any Transaction, the obligation of Buyer to transfer Equivalent Securities to Seller on the Repurchase Date gives Seller a fresh proprietary interest in the Equivalent Securities.

4.1 The effect of the obligation to deliver Equivalent Securities

Under English law, where a person has a contractual right to require the delivery of an asset and the courts would be prepared to grant a decree of specific performance to enforce the delivery obligation, he is treated as having the beneficial ownership of that asset. Accordingly, where the *lex*

situs of the Securities constituting the Equivalent Securities is English law, then if Seller could obtain such a decree in respect of Buyer's obligations to transfer Equivalent Securities, Seller would be the beneficial owner of the Equivalent Securities and Buyer would hold the Equivalent Securities on trust for it.

An order of specific performance is a discretionary remedy and whether it will be given in any case will, therefore, depend on the circumstances. Generally, the courts will order specific performance where a failure to perform cannot be adequately compensated for by an award of damages, but not otherwise. The courts have previously taken the view that where a person owns assets which are not readily available (i.e. where their equivalent cannot be readily obtained from another source), damages may not be an adequate remedy for a breach of an obligation he has accepted to transfer them, and this will justify an order of specific performance. However, a court will not usually order specific performance of an obligation to transfer an asset where the obligee may fulfill his obligations to a counterparty either by transferring the asset or by doing something else.

Whether Seller has, as a result of Buyer's obligation to transfer Equivalent Securities, a proprietary interest in the Equivalent Securities, will depend on the liquidity of the Securities which comprise the Equivalent Securities. If the Securities are readily available in the market, specific performance would not, in our opinion, be available and so this obligation of Buyer would not give Seller a proprietary interest in the Equivalent Securities. On the other hand, if the Equivalent Securities are very illiquid, so that there is only a very limited market for them, following the Repurchase Date, a decree of specific performance probably could be obtained by Seller to enforce Buyer's obligations. At least at that stage, therefore, Seller probably would have a proprietary interest in the assets. In the present case we have assumed that, in respect of any transaction, all the Securities comprising the Equivalent Securities are liquid. The issue therefore would only arise if this were to cease to be the case prior to the Repurchase Date.

4.2 The effect of the agreement to pay Income to Seller and vote in accordance with its instructions

It might be argued that Buyer's agreement in paragraph 5 of the GMRA to pay to Seller any Income which is paid in respect of the Purchased

Securities could be construed as involving an assignment of, or a declaration of trust over, Buyer's rights to that Income. Similarly, it might be argued that the arrangements in the Equities Annex regarding the exercise of voting rights could be construed as involving an assignment of, or a declaration of trust over, the voting rights attached to the Purchased Securities. However, for the same reasons that we do not consider that this agreement would be construed as the *reservation* of a proprietary interest in respect of the Purchased Securities (see paragraphs 2.4 and 2.5 above), we do not believe that it would be construed as the creation of a fresh proprietary interest over them, whether in respect of Income or voting rights.

5 Conclusion

Subject to the qualifications set out in this opinion, in respect of each Transaction, following the transfer by Seller to Buyer of the Purchased Securities, in our opinion, Seller will have disposed of its entire proprietary interest in the Purchased Securities by way of sale.

6 Reliance on this opinion

This opinion is addressed to you solely for your benefit in connection with the issue of the Notes. It is not to be transmitted to anyone else, nor is it to be relied upon by anyone else or for any other purpose or quoted or referred to in any public document or filed with anyone without our express consent. However, a copy of this opinion may be provided by Lehman Brothers to its auditors for the purpose of preparing the firm's balance sheets. We accept no responsibility or legal liability to any person other than the addressees specified above in relation to the contents of this opinion.

Yours faithfully

/s/ Linklaters

Linklaters

