



## INTERNATIONAL INVESTMENT UPDATE

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From our offices throughout the United States, Europe and Asia, the International Trade and Arbitration group assists companies, governments and trade associations worldwide on transactional, regulatory, dispute settlement and policy matters. Success in the global marketplace requires an understanding of the rules that today govern every aspect of the international economy. Our team of seasoned negotiators, dealmakers, litigators and policy advisers draws on extensive private sector and government experience to help companies and governments shape these rules and resolve disputes arising under them.

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Sidley represents dealers, end users and intermediaries in all aspects of exchange traded and over the counter derivatives, including their documentation, their integration into structured transactions and the application thereto of regulatory, tax and bankruptcy law. Product types range from the traditional, such as interest rate, cross currency, equity and credit derivatives, to the exotic, including weather derivatives and catastrophe bonds. In addition, Sidley lawyers were principal authors of the treatise "Derivatives: Law and Practice," soon to be published by Aspen Publishers Inc.

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## **Banks Facing Prospect of Substantial Losses as Derivatives Counterparties Seek To Terminate Deals in Light of Global Downturn**

Recent radical swings in commodity and currency values have prompted holders of certain derivative and option contracts to seek to avoid their obligations, leaving their counterparty banks to suffer the corresponding financial effect of a volatile market. In a worrying trend, courts in certain emerging markets have begun to side with the holders of the contracts. If these decisions stand, not only will the banks incur potentially enormous financial losses, but the resulting legal uncertainty will make financial institutions wary of entering into these types of arrangements in these and other developing markets in the future. Affected banks should consider the full range of options available to them to protect their contractual rights, including the possibility of international arbitration available under applicable investment treaties.

### **Courts Are Increasingly Siding with Local Companies Seeking To Void Hedging Contracts**

The most prominent recent example of this problem has arisen in Korea, where a series of preliminary Korean court decisions has called into question the enforceability of certain "knock-in knock-out," or KIKO, currency contracts. Several years ago, many Korean small and medium-sized entities (SMEs) entered into KIKO contracts on the expectation that the Korean won would continue to appreciate, adversely affecting the profitability on their export sales. To protect against this eventuality, the SMEs entered into KIKO currency hedging arrangements, in which they purchased won call options and sold won put options. However, the value of the won unexpectedly depreciated in 2008, and the SMEs faced the prospect of substantial losses on their put options. Rather than make good on their contractual obligations, a number of the companies commenced court actions to invalidate the contracts.

According to the International Swaps and Derivatives Association (ISDA), there were more than 330 cases pending in Korean courts as of March 10, 2009, while decisions had been handed down in eleven cases. In two cases, the courts ruled in favor of the

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banks, but only on grounds that the banks had advised their counterparties to enter into stop-loss arrangements before the losses grew too large. In four cases, the courts issued preliminary injunctions suspending performance of the hedging contracts on grounds that “changed circumstances” had fundamentally altered the expectations underlying the contracts when they were signed. The Seoul Central District Court has since rejected the “changed circumstances” rationale but has still granted preliminary injunctions in a number of cases on grounds that the banks had failed to notify the buyers of the risks of the KIKO contracts.

In a second prominent example of the problem, the Ceylon Petroleum Corporation recently sought to extricate itself from oil derivatives contracts it entered into with several multinational banks. According to press reports, under the terms of the deals, the banks were to pay Ceylon Petroleum if the price of oil rose above \$140/barrel, while Ceylon Petroleum would pay the banks if the price fell below \$100/barrel. As the price of oil plummeted from historic highs, Ceylon Petroleum faced large losses on the contracts and refused to continue payments. A subsequent interim ruling by the Supreme Court of Sri Lanka prevented Ceylon Petroleum from making payments on grounds that the contracts were tainted with corruption. This decision was later followed by a similar order from the Sri Lankan central bank. Several of the affected multinational banks have commenced arbitration either under the arbitration clauses in the underlying contracts or, in the case of Deutsche Bank, under the arbitration provisions of the German-Sri Lanka bilateral investment treaty (BIT).

### **International Investment Treaty Arbitration Can Be an Effective Way To Preserve Contract Rights**

Given the continued deterioration of global economic conditions, such problems are likely to spread and potential bank losses will continue to rise. In devising an appropriate response, financial services companies should consider not only their legal options in domestic courts or under contractual

arbitration clauses, but also the option of proceeding under the arbitration clauses of applicable BITs.

BITs are treaties between governments that are designed to protect cross-border investments from one country into the other (they do not protect investors or investments against actions by their home governments). They provide an array of protections against government action that may be stronger than remedies available under domestic law. Such protections include an obligation by the government to pay compensation for expropriation of property, including contractual rights; a prohibition against discrimination on the basis of nationality; and a guarantee of fair and equitable treatment in all cases including actions taken by courts.

BIT protections are directly enforceable by the private investors from one BIT country through international arbitration against the government of the other country, regardless of whether any underlying contract contains an arbitration clause. Should the investor prevail in BIT arbitration, it would be entitled to monetary compensation from the foreign government for any damages incurred as a result of a breach of the BIT. As noted, Deutsche Bank has already commenced arbitration under a BIT to challenge the Sri Lankan government’s interference with its rights under its derivatives contract with Ceylon Petroleum. While no arbitrations have been initiated against Korea on the KIKO issue, Korea is a party to 87 BITs, including with major sources of outbound investment such as the United Kingdom and Germany.

Banks should therefore consider how to structure their ongoing derivatives business to ensure the availability of BIT protections. While there are over 2,500 BITs in force around the world, the number of BITs varies significantly from country to country. For example, Japan is party to only a dozen BITs, while the United States has negotiated 47, and the United Kingdom and Germany have each negotiated over 100. These figures do not include trade agreements that may include investment protections similar to BITs. Because entities

organized in a country that is a party to a BIT benefit from BIT protections, as do subsidiaries of these entities wherever located, banks should, where possible, use such entities (or subsidiaries) as the counterparty in derivatives transactions.

## Conclusion

In dealing with the rapidly changing economic landscape, financial institutions need to consider all options available to them to protect their rights. Investment treaty arbitration can be an effective tool, supplementing the more familiar tools of domestic litigation and international commercial arbitration.

Investment treaty arbitration can be particularly effective in a domestic legal environment that may be uncertain, biased, or marked by a weak rule of law – problems that are only exacerbated by the financial crisis. The situations described above are good examples of when international investment

arbitration can be used to ensure that fundamental contract rights are preserved even in cases of economic adversity.

Sidley's unique team of practitioners combines extensive experience in investment treaty arbitration and international commercial arbitration with a leading global securities and derivatives practice.

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