Transaction Formalities: Peril Amplified in Cross-Border Transactions

Formalities impact transactions. They are more than a mere logistical exercise; they matter. A recent English case – which turns on the failure to obtain a single handwritten signature – demonstrates that not complying with formalities can result in catastrophe. That case also demonstrates how bad facts can make bad law, and it provides fertile ground for a number of questions. Above all, that case serves as a reminder to transaction parties and their counsel to exercise vigilance as they structure and execute their transactions, particularly where conflicts of law issues are involved.

1. Complex logistics to file one original document

This firm acted on a cross-border financing of new and pre-owned assets that recently signed and partially funded. That transaction demonstrates how complying with relatively simple formalities can quickly turn into an involved logistical exercise.

There, to finance the new assets for use in one country, a government agency in that country required the only substantive document filed with it to be a notarized and apostilled original document. This is because that document, which was governed by the law of a second country,[1] had to be signed by a party located in a third country.[2] Without the notarization or apostille, the government agency could neither accept the filing, nor recognize the purported effect, of the document. Further, that government agency, which does not supply forms of documents that are acceptable to it, required a draft of that document and the language given by the notary as to due execution to be submitted to it for pre-approval.

The complexity of the logistics escalated because the mix of factors included back-to-back filings on each asset that would occur during a delivery period, multiple parties (each with its own counsel), a split of responsibilities among them, and linguistic hurdles. The difficulty of the challenge compounded: these logistics had to be determined in a compressed timeframe months before any filings were to be made, because the master transaction documents had to be signed to permit the simultaneous financings of pre-owned assets in a fourth country, which had its own set of formalities.

2. Formalities matter; analyzing conflicts of law

A spectrum of consequences can result from the failure to comply with formalities. A relatively minor consequence is that closing is delayed. Significantly, the failure might vitiate an agreement or result in liability for one of the transaction parties. In this respect, the English high court issued a decision late last year which turned on the failure to properly sign a non-English law document that supported an English law financing.[3]

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[1] Counsel for the lenders imposed this requirement.
[2] This fact reflects an inflexible, yet standard and reasonable business practice.
[3] Golden Belt 1 Sukuk Company BSC(C) v BNP Paribas; FCOF II UB Securities LLC and others v BNP Paribas, [2017] EWHC 3182 (Comm).

The holding

The high court held that the arranger of a sukuk:[4] owed a duty of care in respect of the transaction it arranged to both the primary and secondary institutional investors even though the investors were not clients of the arranger for the purposes of the transaction; and breached that duty when it failed to ensure the promisor and credit, a Saudi Arabian entity, had signed in handwriting a Saudi Arabian law promissory note that was intended to backstop the sukuk. The court also held that the disclaimer of liability in the offering circular did not absolve the arranger of liability because the disclaimer language did not specifically exclude from the arranger's obligations the action of verifying signatures of the parties to the transaction documents.[5]

There, the signature appearing on the promissory note had been laser-printed. The print quality was so excellent that only microscopic inspection conducted as part of the litigation revealed that the signature of the promisor was not handwritten. Further muddying the waters was that the two witnesses to the signature of the promisor had added their handwritten signatures in the accompanying signature blocks.

The judge did not limit the application of the judgment to solely the facts of this case. An appeal is pending, and it is not clear that the judgment has been stayed pending the outcome of the appeal. Without a limitation on the scope of its application, the holding of the case is unsatisfactory: arrangers will have to devote resources in each transaction fine tuning their disclaimers to address a universe of possibility when the text of an effective disclaimer should be a matter of settled law; and sophisticated institutional investors who invest in English law governed fixed income securities could seek to rely on this case to play a high stakes game that trades on this formality, knowing that arrangers may have to backstop all or a part of the investments.[6]

The court's reasoning

The court reasoned that the arranger had assumed and breached a duty to the investors when, among other things, it failed to perform the obligations it told its client it would perform. These obligations included hiring the lawyers to paper the transaction, but it was the arranger, not counsel, who made arrangements for the execution of the transaction documents. Expert testimony was unanimous that in other fixed income capital markets transactions, the arranger, not counsel, is responsible for due execution. One expert stated this was the case even where the task of ensuring due execution is outsourced to external counsel.

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[4] A sukuk is a sharia-compliant fixed income financing typically provided by institutional investors. In this case, institutional investors purchased English law limited recourse certificates supported by the cash flows generated by leases with the arranger's sole client in this transaction, the promisor.

[5] Evidence included that the statement of risks in the offering circular failed to identify the risks that: the promissory note would not be enforceable in Saudi Arabia; and the promisor would fail to execute any of its transaction documents in accordance with applicable law. However, these facts were absent from the court's reasoning, which focused on the content of the disclaimer.

[6] The facts underlying the case are vibrant. For example, after the initial offering of the securities the New York-based distressed debt investors purchased their securities knowing that both the promisor and its general partner, a Saudi Arabian individual, had been sued by third parties in Saudi Arabia, New York, and the Cayman Islands for fraud (including forgery and giving phony guarantees) and money laundering in transactions unrelated to the securities offering. A Saudi Arabian royal decree absolved both the promisor and its general partner for fraud after the secondary investors purchased their securities, yet the promisor and the general partner filed for bankruptcy protection in Saudi Arabia, and the fraud cases in New York and the Cayman Islands remained ongoing. To keep the length of this article manageable, it focuses on key facts with other, supporting facts appearing in the footnotes.

An additional, yet key, consideration for the court was that the purpose of the promissory note was to give the institutional investors direct recourse to the promisor. Obtaining a handwritten signature was of paramount importance, because evidence confirmed that the market was generally aware that a common defense in Saudi Arabia to the enforcement of a promissory note was to claim that that the signature appearing on it was fraudulent.

Actual damages were reserved to a further trial

The court defined the measure of damages the secondary investors suffered as the difference between (a) recovery the investors could have obtained on the basis of a valid promissory note and (b) their actual recovery, but reserved to a future trial the actual amount of those damages. The reasoning included that the promisor and its general partner had been absolved of wrongdoing in Saudi Arabia. Although a tribunal for the orderly determination of creditor claims was set up, no claims of non-Saudi Arabian creditors had been satisfied in the eight years since the tribunal had been created.

The arranger's defenses; the court's rejection of those defenses

The arranger defended itself, among other things, on the bases that: it relied on advice from Saudi Arabian counsel; lead English counsel, a global law firm, had committed malpractice; verifying due execution constituted the practice of law fitting within the entire purview of lawyers; and the promissory note was of marginal importance to secondary investors who had the wherewithal to evaluate the transaction.

The court rejected the defense that the arranger had relied on the advice of Saudi Arabian counsel, because the arranger had failed to follow the advice of Saudi Arabian counsel.[7] Saudi Arabian counsel had advised two courses of action, both of which required an original signature on the promissory note. However, the arranger allowed the promisor to execute the promissory note outside of the arranger's control (including having its Saudi Arabian counsel attend the signing), and no one verified that the signature was handwritten. Further, the arranger failed to keep Saudi Arabian counsel informed as to how the arrangements for the signature of the promissory note progressed.

The court rejected the defense that English counsel had committed malpractice on the basis that the arranger had not sued English counsel for malpractice and, in any event, English counsel remained on the arranger's panel of law firms.[8]

The court side-stepped the issue whether the arranger could practice law on the bases that the promisor had capacity to give the promissory note and the signatory was duly authorized to sign the promissory note.[9]

The court acknowledged that the secondary distressed debt investors who sued had conducted due diligence on the transaction and that they were aware of the pending fraud claims, but that they

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[7] Evidence included that commercial concerns, including strong desires to prove to the market that it could arrange a sukuk and to further improve its business ties with the promisor, dictated the arranger's actions.
[8] (a) The decision does not explain why the arranger did not sue its English counsel for malpractice. Evidence recorded in the decision, however, suggests a reason: even though the arranger's legal department sent internal emails during execution that were scathing of the work performed by English counsel and criticized the lack of partner involvement, the legal department allowed the transaction to proceed, rather than find replacement English counsel. (b) The decision also does not explain why the court identified the under-supervised female associate who ran the transaction while allowing the absentee partner to remain anonymous.
[9] These statements are inconsistent with: both the omission in the case of any facts confirming the capacity in which the signatory signed the promissory note and on what basis the signatory signed it; and the facts underlying question B(4) which are set out in its accompanying footnote 11.

were still entitled to rely on the arranger to have ensured proper execution of the promissory note. The court never specified whether any of the primary or secondary investors was represented by counsel at any point when they conducted due diligence on the sukuk.

Multiple questions arise

The case generates numerous questions, such as:

A. Procedural issues

1. Why was the case not dismissed for failure to state a claim; the investors' total damages were unknown?
2. Since none of the primary investors sued the arranger, why was it appropriate to hold that the arranger owed a duty of care to any of them?

B. The promissory note itself

1. Under Saudi law, was the Saudi Arabian Royal decree absolving the promisor and its general partner of fraud sufficient to reinstate the validity of the promissory note?
2. Why, under English law, was the Saudi Arabian Royal decree absolving the promisor and its general partner of fraud insufficient to show that the arranger had, in fact, acted reasonably in allowing the promisor to execute the promissory note?
3. Why are the laws of countries other than Saudi Arabia relevant for interpreting the law in Saudi Arabia as to due execution?[10]
4. In light of the importance of the promissory note, why did no one require the promisor to hire its own counsel to issue an enforceability opinion to the investors covering the promissory note that included an opinion on delivery of the signature?[11]
5. When considering whether a duty of care had been breached, why did the court pay lip service to, but otherwise appear to disregard, evidence that even if the promissory note were valid, enforcement of the promissory note would not be automatic and that recovery might not be forthcoming, if at all?

C. Obtaining a judgment in England against the promisor and the general partner

1. Why did no one sue the promisor and its general partner for fraud under English law?
2. Related to question C(1): the issuer of the certificates the investors purchased had its claims against the arranger dismissed on the basis that it was a mere conduit for the flows of funds through the sukuk. An issue unaddressed by the court is whether claims relating to the investors' funds[12] flow with the funds so that investors could have sued the promisor directly for those claims in addition to suing for claims based on the transaction structure.
3. Conversely, why, from an English law perspective, did the laser-printed signature not constitute evidence of intent to be bound by the promissory note?

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[10] No one questioned the advice from Saudi counsel that a handwritten signature on the promissory note was required, yet the court admitted expert evidence of practices of other GCC countries to determine whether a handwritten signature was required under Saudi Arabian law.

[11] The comfort given by the arranger's Saudi Arabian and English counsel included legal opinions that opined on validity and enforceability, but their assumptions rendered both opinions worthless: the Saudi Arabian legal opinion assumed authentic and true documents and that all signatures were genuine, and neither the English legal opinion nor the Saudi Arabian legal opinion, opined on valid execution. Had the promisor's Saudi Arabian counsel been required to witness execution of the promissory note and provide an enforceability opinion covering the promissory note, it would only have been able to rely on an assumption as to the genuineness of the signatures.

[12] For example: unjust enrichment, conversion, or theft.

4. How did the promisor execute the other transaction documents? The case merely suggests that the absence of claims relating to those documents implies that they were correctly executed.
5. The case does not specify that the promisor was represented by English counsel, including to verify that the arranger's lawyers had papered the transaction correctly. If not, why not? Would the arranger have been found liable in tort had it required its client to hire counsel?

D. <u>The initial and subsequent purchase agreements for the certificates</u>

1. Why did none of the purchase agreements for the certificates include a clause to the effect that the investors were sophisticated investors who had an opportunity to be advised by counsel before purchasing the certificates?
2. Alternatively, if that clause were included in the purchase agreements for the certificates, why did the decision omit that fact, and why did that fact not impact the finding that the arranger owed any of the investors a duty of care?
3. Why did no party sue for breach of warranty under the initial certificate purchase agreement where an express warranty covered due execution?

E. <u>Sophisticated investors</u>

1. Why did the arranger not elaborate on the secondary investors' ability, as sophisticated, institutional distressed debt investors with significant resources at their disposal, to hire sophisticated counsel to review the transaction documents and legal opinions?
2. Why was it appropriate to allow the investors to assume that the arranger knew what it was doing, when in fact this was the first sukuk the arranger had structured? Had that fact been disclosed to the investors?

3. Final thoughts

Conducting business outside of one's home jurisdiction is an exercise that requires advance planning and care. One cannot assume that the social customs and legal principles that undergird one's domestic transactions apply elsewhere. Transaction parties and their lawyers must, therefore, work to understand both what is required and how they will provide it while managing commercial concerns that may seek to impose their will on how a transaction is structured and executed. They must be unafraid to question the transaction to ensure that issues germane to both its form and substance have been identified, analyzed, and resolved.

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