Feature

KEY POINTS

- A right of last look can be used by a seller in an auction process to enable its preferred bidder to match or come closer to a higher bid.
- The very nature of a right of last look can provide a route for the abuse of auctions.
- There is scope for "anti-trust" type behaviour in the conduct of bank auctions to be met with civil or criminal sanctions.

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Rights of last look: a legitimate tool or abuse of the auction process?

The economic crash and the associated financial crisis since 2006/7 have left public trust in financial institutions at an unprecedented low, most recently with the LIBOR fixing scandal. The opaque market place in which the sale of billion dollar assets occurs is coming to the fore and its turn for a stress test by public opinion may be just around the corner. This article explores recent cases in this area and highlights the risks faced by the parties involved in such sales. It looks to focus on the role of auctions and methods of sale and in particular the "right of last look".

INTRODUCTION

In recent years financial institutions have been under increasing pressure to alter the structure of their portfolios to meet regulatory requirements in an attempt to stabilise global markets.

The impact of increased regulation has forced banks to review internal business models to right size their respective balance sheets via deleveraging.

From 2007 onwards banks began to divest themselves of assets in order to improve capital ratios, whilst also attempting to decrease pressure on balance sheet funding – ie banks are under pressure to repay LTRO (Long Term Refinancing Operation) funds from their respective central banks.

Unfortunately, the sales environment has not been conducive to securing best value for assets as national regulators implement reforms globally and distribution of debt is occurring wholesale across continents on a large scale (Deloitte anticipate another five years to deleverage the European banking system). Typically, the process used for such asset distributions has been auctions managed by the vendor, or occasionally by agents instructed by the vendor.

The value of the assets being sold is often billions of dollars, euros or pounds, and there is often a perceived direct or indirect public interest in the sums raised where, for example, the assets being sold belong to a "publicly owned" bank.

BWIC AND NPL

There are several ways in which banks distribute assets into markets, however:

- BWIC (Bids Wanted In Competition), ie individual asset sales, eg from loan books or failed debt syndications; or
- NPL (Non Performing Loan) Portfolio sales, are most common.

BWICs

The vendor will, via its respective syndication or loan trading sales area, invite various parties to bid in an auction. In regard to a BWIC, this is an open auction process, sent to potentially hundreds of market participants, in an attempt to attract liquidity to the auction process, and gain insight into price discovery.

Invitees will range from global proprietary trading desks to asset managers, insurance companies, or indeed large pension funds that are all looking for access to higher yielding coupons/ margins to drive increased returns whilst diversifying their underlying asset portfolios. Sale prices are dynamic on a number of variables. The BWIC processes operate inside of a private market and as such are not governed as stringently as public paper, bonds or equity.

NPLs

The NPL process is different. Often, banks assemble larger portfolios of stressed (underperforming) or distressed debt (either defaulted or forecasted to default) which are considered specialist sales. The vendor then issues a limited number of invitations with associated rules and timings for bids. All invitees execute confidentiality letters and non-disclosure agreements, again within a private market environment.

The vendor collates all relevant data on each loan within the portfolio, (credit documentation, financial data, security arrangements, etc), and places the information within a secure environment or "data room". Invitees are then granted access to the data, each one working up a price for the portfolio of debt. Auction participants are likely to be large global investment banks, or distressed asset specialists such as Special Opportunity Funds or CDOs (Collateralised Debt Obligations).

In regard to both BWIC and NPL sales, the lack of regulation, governance and transparency is key and raises questions as regards securing the appropriate sale value.

LAST LOOK AND BID RIGGING

A common feature of the auction processes described above is a contractual provision providing a party (be it the vendor, agent, or prospective purchasers) with the "right of last look".

In the last year a number of high profile cases have illuminated how: prima facie open auctions can be abused; how the right of last look can be an instrument in wrongdoing and; where conflicts of interest can arise.

The overriding message to parties involved in such sales, and in particular to the managers and brokers involved at the coal face, is that their conduct will be subject to ever closer scrutiny whether merited or not, just as the regulatory bodies have had to move with public opinion to oversee other aspects of the financial system.

The issues in play are common to all arenas where auction sales take place, and a grasp of overreaching concepts is important. "Bid rigging", or "collusive tendering" in an auction takes place where competitors cooperate in order to artificially manipulate the price of the asset for sale. Illegal bid rigging between actual or potential competitors may take many forms, including rotation bids, last look bids, protective pricing bids and the like.

A recent example of bid rigging in commercial auctions concerns two oil and gas companies accused of illegally working together in auctions of four natural gas leases from the US Government.

The two companies entered into a written agreement under which they agreed that only one company would bid at the auctions yet would then assign an interest in acquired leases to the other company. The US' investigation resulted from a whistle-blower lawsuit filed under the *qui tam* provisions of the False Claims Act.

Those provisions allow for private parties to sue on behalf of the US and, if successful, to receive a portion of any recovered damages. Financial institutions in the US are already at risk of increased attention from private parties as a result of the False Claims Act. Commentators argue that a similar provision in the UK might open the banking system to greater scrutiny.

A current case brought by the US provides a further example of how easily an apparently fair auction system can be abused, when a right of last look is given to a party.

The alleged bid-rigging scheme was to defraud the US Army Corps of Engineers such that bid prices were manipulated so that a company, BEI, was assured of receiving subcontract work. In one instance, BEI was given a last look at a competitor's bid for doing the work, and thereafter placed a higher quote for undertaking the work. The twist was that the main contractor (implicated for receiving a "kick back") was able to recommend BEI's bid on the basis that the lower priced company was not qualified to perform the work.

Albeit that the "last look" that was offered to BEI was not permissible, it remains that even had it been allowed, where an auctioneer/broker is corrupt or subject to or has undue influence, even a "losing bid" can be turned into a winning bid on an unethical recommendation.

In auctions in the financial market it is common for low but passive bidders to be accepted in preference to what might be seen as aggressive bidders, be they Gordon Gekko or similar.

Preferred bidders enable a vendor to control the likely end-buyer, whose behaviour in that market place thereafter can be predicted, such as holding and carefully managing the divested asset(s) post sale. The motivation for a vendor wanting the assets to go to "a good home" can be multifaceted.

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It may assist the relationship between the selling bank and owners of the affected business (eg shareholders), by preserving future fee income to the bank as the same owners are often introducers of new business. Alternatively, the seller may want to manage the characters who will enter the product environment after the asset is sold, particularly where the seller will retain assets in or exposure to that environment after the sale. However:

- the seller's view of what after sale control/stability is required in the market place and at what reduced price, may differ from that of onlookers such as the "general public", which may legitimately press for change to the status quo, particularly where that will realise greater value for assets in which the public has an interest; and
- the person given the power to label a party as a "preferred bidder" (often the manager auctioning the asset) may, as in the BEI case above, be subject to undue influence.

The right of last look has recently taken centre stage in a criminal prosecution of bankers in the US in a trial the press has postulated "will go down in history as the first trial of the modern American mafia".

The prosecutor in *United States of America v Carollo, Goldberg and Grimm* provides a neat introduction to the case:

> "Even though some aspects of municipal bond finance are complex, the fraud here was simple … it was about lying and cheating cities and towns in a bidding process that was in place to protect them".

The "simple fraud" described centred around public borrowing, where, for example, a town has a bond issued to raise $100m to build a new school. Once the money is raised, it is placed in an account ready to pay for the project. While that money is on deposit in the town's account, the town's officials look for a financial company to invest it for them.

A broker is hired to set up an auction and invite banks to compete for the town's business. The towns and cities, called issuers, are legally required to submit their bonds to a competitive auction of at least three banks, called providers. However, it was asserted that providers divvied up the business of all the different cities and towns that came to Wall Street to borrow money.

The auctions were rigged by bribing the auctioneers/brokers. Instead of holding what has been described as "honest auctions" in which none of the parties knew the size of one another's bids, the broker would tell the prearranged winner what the other two bids were, allowing the bank to lower its offer and come in with an interest rate just high enough to beat its supposed competitors.

This right of last look has been described in the context of this case as a "*simple but effective cheat*", thus highlighting whether such a right can persist as a legitimate tool even when provided in an open manner.

Put otherwise, the very nature of the right of last look can provide a route for the abuse of auctions, which prime facie appear legitimate.

> ...the right of last look is simply seeking to retain the "open room" bidding process.

The following example excludes criminal wrongdoing: Terms and conditions for an auction make it explicitly clear that the offeror reserves a right of last look to X. Absent that right, X may well have made a sealed bid of £20 against the next highest bidder's £15. Knowing it has a right of last look, X makes a low bid of £5, and when given the right of last look simply ups its bid to £16.

It is arguable that the process which reserved a right of last look has failed to obtain the best true market value of the asset at auction. However, a traditional "open room auction" has always honoured the "last look" principle – each bidder can hear the bid their rival is making, and choose to increase their own bid before the hammer falls.

It may well be that Mr Smith is willing to pay £100,000 for a house, but if the next highest bid he hears in the auction room is £70,000, he only needs to bid £75,000. Put simply, the right of last look is simply seeking to retain the "open room" bidding process. Yet it remains arguable that a paper auction that incorporates a right of last look takes a positive feature of an open room auction for the purchaser, without the positive features of that process for the vendor: namely the charged atmosphere and the fact that competitors for the asset must immediately respond to one another's bid; an effect which can lead to the seller obtaining a full or even inflated price for their asset.

In the *Carollo*, *Goldberg* and *Grimm* case it has only been possible to speculate on the sums lost to the towns and cities over a period put as being "*at least a decade long conspiracy*". However, four banks that were implicated in the affair (UBS, Bank of America, Chase and Wells Fargo) paid $673m in restitution after agreeing to co-operate in the Government's case. That settlement involves only four of the firms implicated in the affair (a list that includes Goldman, Transamerica and AIG, as well as banks in Scotland, France, Germany and the Netherlands).

It has been suggested that:

> "since settlements in Wall Street cases tend to represent only a tiny fraction of the actual damages it's safe to assume that Wall Street skimmed untold billions in the bid-rigging scam."

SELF SALES

The scope for market abuse becomes even more apparent once it is appreciated that the party tasked with managing the auction often hopes to acquire the asset for itself.

In the UK the recent case of *Royal Bank of Scotland Plc v Highland Financial Partners LP & Oths* provides an example of where an outwardly transparent auction process can be abused by a bank.

RBS had advanced €240m (the RBS Loan) in respect of a proposed collateralised debt obligation transaction. The advances were to be used to acquire a portfolio of loans (the Portfolio Loans) which were then to be used as collateral for securities offered to the markets.

There was a closing date when the RBS Loan was to be repaid, the expectation being from the securities. This was in late 2008. Given the prevailing economic climate, no securities were issued, and RBS sought repayment. The contractual arrangements required the acquired loans to be sold by RBS.

RBS purported to use a BWIC process to liquidate the portfolio. In this case RBS was entitled to match the highest bid and acquire a Portfolio Loan itself.

RBS had a particular incentive to retain some of the loans, namely an amendment by the International Accounting Standards Board to International Accounting Standard 39 (which came into force on 13 October 2008) which permitted banks to transfer, on a one-off basis, certain assets on their trading books to their banking books at their 30 June 2008 mark to market value. As the Court found, IAS/39:

> "was an answer to the real and pressing financial and accounting problems caused by the crash of autumn 2008
>
> … The enormous benefit of this was that, instead of having to write down the value of such loans on their books
>
> … they would be entitled to value the asset at a date which could be adopted retrospectively by the bank … This would have the effect of enabling the bank to write back the losses for which it would otherwise have had to account."

36 of the 88 Portfolio Loans were selected by RBS. The Court found that by:

> "31 October 2008, i.e. 7 days prior to the opening of the BWIC, it had already been decided, and indeed…put into effect, that the 36 Loans would be retained by RBS in order to take advantage of IAS/39".

The Court went on to note:

> "This caused real problems for RBS's salesmen, who…were not told which of the loans ostensibly in the BWIC were for sale… This inevitably led to deception and difficulty".

Accordingly, it was found that:

> "the 'commercial objective for the bank' was to secure the 36 Loans

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for themselves, and simply use the BWIC… as a 'price-fixing exercise' [or, more accurately, as I should have said, a 'pricing exercise']…

In respect of 36 of them, the BWIC was a 'sham'. Lies had to be told, and there could be no possibility of high pressure salesmanship to force up the prices by the RBS sales force…

Irrespective of whether the sales force knew which Loans were and which were not for sale, the bifurcated exercise of simply 'price fixing' for the 36 (which were to be purchased by RBS, in whose interest clearly a lower price would be advantageous) and doing an actual sale exercise with regard to the 52, particularly if it was indeed coupled…with a false backup story fed to the sales force…was bound to involve a serious conflict of interest".

The defendants in the case argued that the sum outstanding to RBS from it would have been less had a proper sale process taken place. Later in proceedings RBS sought to argue that, in any event, it retained a right of last look which it could have used to retain the loans in the auction process.

However, the Court repeated that the result, had a right of last look been used, would have still been unjust given the:

"absence of any real prospect of pushing up the price being offered by any third party… [by] a sales force inhibited from pushing up the prices".

Accordingly, in the RBS case, were a contractual right of last look employed, given the relative ease with which the sale process could be managed by RBS to stifle price, that prima facie legitimate right could simply be a cog in a sham auction process.

CIVIL CLAIMS

There are well established causes of action in contract, tort and equity open to a buyer or seller against one another or a broker/auctioneer, where they are wronged in an auction process.

The claims against RBS by its borrower included fraud and unjust enrichment, with the Court focusing its finding on:

- a breach of contract, namely that a sham auction process could not satisfy the bank's contractual obligation to act in "a commercially reasonable manner"; and
- a breach of the equitable obligation of good faith owed by RBS, as mortgagee exercising a power of sale.

Towns and cities who were victims in the *Carollo*, *Goldberg* and *Grimm* case have, unsurprisingly, sought damages from the banks involved in civil suits, and settlements have been reached.

There are a myriad of circumstances in which interested third parties may feel aggrieved by the manner or result of auction sales of bank assets, where the right of last look is used (lawfully or unlawfully).

As noted, a right of last look can be used by a seller to enable its preferred bidder to match or come closer to a higher bid. The Administrative Court in the UK is traditionally concerned with challenges to the decisions of public bodies through the procedure of judicial review, but applicants continue to push the boundaries of when a given body may be amenable to judicial review.

It will likely be a matter of time until an applicant seeks to argue that a decision of a public funded/owned bank in respect of the sale of its assets can be scrutinised by way of a judicial review.

At the very least, in that recognised public bodies tasked with regulating banks are seen as being inactive in that function of regulation (as some commentators argue the UK bodies are compared to their US cousins), so that inactivity may be susceptible to judicial review to force action.

There are numerous reported cases concerned with collusive tendering where a public body, the Office of Fair Trading (OFT), is a party, with dispute focused on breaches of the Competition Act 1998. Cases to date tend to have been dominated by the construction industry.

In short, Chapter 1 of the 1998 Act prohibits agreements between undertakings or concerted practices which prevent, restrict or distort competition. The banking industry is no stranger to the OFT, and there is obviously scope for "anti-trust" type behaviour in the conduct of bank auctions which may be met with civil or criminal sanctions, should appropriate cases arise.

Furthermore, the recent decision in *Quarmby Construction Co Ltd & Oths v OFT* [2011] CAT 11 determined that the OFT's power to impose fines for infringements of the Chapter I prohibition in the Competition Act 1998 was not subject to any limitation period, leaving wrongdoers at risk of sanction long after market abuses.

As to the competitors who lose out where auction processes are abused whether by a right of last look or otherwise, the developing body of economic torts may provide a cause of action to seek recompense. Of particular note is the tort of conspiracy to injure by lawful means, whereby two or more parties conspire with the predominant purpose of deliberately damaging a third party, such as collusion between bidders.

Since 2008 there have been numerous auctions of bank assets in which the public has a direct interest. It may well be that in the near future cases will come to the fore concerning the manner of those auctions.

Looking forward, some commentators observe that this is an area that demands stricter regulation to prevent or reduce the scope for market abuse, in particular where public assets are in issue. ■

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