

CLIENT ALERT

Finding More Certainty - Are Your Counterparty's Oral Promises Enforceable?

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When can a mere phone call, an e-mail, a Bloomberg message, a voicemail, or a note scribbled in a trader's notebook create an enforceable promise?

We're not talking about formal contracts, drafted with the luxury of time, negotiated by lawyers and ultimately signed by all parties. We're talking about communications between parties that may happen quickly, under the stress of circumstances, in the fog of a volatile market. Communications that are not reduced to a written document that gets executed and delivered by all parties.

A contract is a promise, the breach of which the law provides a remedy, or the performance of which the law recognizes as a duty. But the clever circularity of this legal definition isn't much help. Exactly when and at what point does the law provide a remedy for a broken promise? Precisely which counterparty utterances create a duty to buy or sell a financial instrument and ultimately settle the trade?

In times of market stress, market participants focus on whether unsettled trades (particularly oral trades which are not evidenced by a signed trade confirmation or an exchange of trade re-caps) are "binding and enforceable" against counterparties that are unwilling or unable to settle. The risk of an unenforceable trade is acute when prices are volatile and liquidity dries up, because dramatically falling prices can tempt a remorseful buyer to walk from a trade.

A brief summary of our view regarding enforceability of trades governed by New York law follows:

- As a general rule, oral contracts are enforceable provided that there is sufficient evidence of the parties' intent to be bound. While the New York Statute of Frauds provides that certain oral contracts, including contracts for the sale of goods for \$500 or more, are unenforceable unless reduced to a writing, the modern "qualified financial contract" exemption to the New York Statute of Frauds permits the enforcement of an oral agreement for certain types of sophisticated financial transactions involving currencies, commodities, derivatives, as well as loan and claims trades.
- Under New York General Obligations Law § 5-701, an oral trade that is valid in other respects will be enforceable if (i) it qualifies as a "qualified financial contract" (e.g., a loan or claims trade), and (ii) there is "sufficient evidence" to indicate that a contract has been made. "Sufficient evidence" includes electronic communications (e.g., e-mails, trade recaps, voicemails), as well as a safe harbor for trade confirmations communicated by one party and not promptly objected to by the other.
- In times of market stress, non-defaulting parties will be in a better position to enforce their in-the-money trades (and assert that the trade falls within the qualified financial contract exemption) if they have created a clear and specific record, in oral or written communication, proving the material terms of the trade (e.g., price, quantity, key documentation terms, etc.). For example:

- Traders should pin down material terms that would create problems if the counterparty were to attempt to change them later.
- Traders should reach express oral agreement on those terms on the trade date and should include those key terms in their confirmations, trade recaps or other contemporaneous counterparty communications.
- Traders should have procedures for creating “sufficient evidence” of the trade on the trade desk. Blotters, e-mails, Bloomberg messages and trader's notes are all sources of evidence supporting contract formation. Traders should design operational processes to capture and preserve such evidence.
- To the extent certain counterparties are “repeat offenders” who often try to change terms of trades after confirmations have gone out, consider a master agreement shortening the time in which such counterparties must either object to material terms of the a trade confirmation or be deemed to have countersigned the confirmation. The governing time period of the “sufficient evidence” safe harbor can be amended by written agreement of the parties.

For more information, please contact the professional(s) listed below, or your regular Crowell & Moring contact.

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