

New York Commercial Division Round-Up

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[ISDA Agreements Between Banks And Mexican Corporation Are Enforceable Despite Illegality Defense Due To Choice Of Law Clause In Agreements](#)

By [Mark McGrath](#)

In four related cases, *Merrill Lynch Capital Markets AG and Merrill Lynch Capital Services, Inc. v. Controladora Comercial Mexicana S.A.B. De C.V.*, Index No. 603214/2008 (Sup. Ct., NY County, March 16, 2010), *JPMorgan Chase Bank, N.A. v. Controladora Comercial Mexicana S.A.B. De C.V.*, Index No. 603215/2008 (Sup. Ct., NY County, March 16, 2010), *J. Aron & Company v. Controladora Comercial Mexicana S.A.B. De C.V.*, Index No. 603225/2008 (Sup. Ct., NY County, March 16, 2010), and *Barclays Bank PLC v. Controladora Comercial Mexicana S.A.B. De C.V.*, Index No. 603233/2008 (Sup. Ct., NY County, March 16, 2010), Justice Eileen Bransten recently granted summary judgment on liability to the plaintiffs against Controladora Comercial Mexicana S.A.B. De C.V. (“CCM”), one of Mexico’s largest retailers and the operator of approximately 200 stores and 70 restaurants. In each of the cases, the plaintiff asserted breach of contract claims and CCM asserted the same affirmative defenses and counterclaims, which defenses were found to fail by Justice Bransten. Of particular interest was the court’s rejection of CCM’s defense that the agreements were illegal under Mexican law and, thus, could not be enforced.

Since CCM imported goods and borrowed money, all of which were denominated in dollars, CCM sought to limit its exposure to fluctuations in the exchange rate between dollars and pesos and control debt service costs by entering into derivatives transactions. CCM entered into agreements with each of the plaintiffs (except for J. Aron & Company, which is the assignee of Goldman Sachs Paris Inc. et Cie) relating to foreign exchange and interest rate derivatives based on the standard form Master Agreement and Credit Support Annex issued by the International Swaps and Derivatives Association, Inc. (“ISDA”). Each of the agreements is governed by New York law and contained a schedule modifying certain terms of the ISDA form agreement and each had a credit support annex (hereinafter, the agreements, schedule and annex will be referred to as the “ISDA Agreements”). The ISDA Agreements set forth the structure for and governed any derivative transactions between the parties, and each agreement contained representations regarding authority, validity, legality and enforceability. The sum and substance of the representations is substantially the same in the ISDA Agreements. In particular, each of the parties to the ISDA Agreements represented:

- there is no fiduciary or advisor relationship between the parties;
- it is not relying on any representations of the other party other than what is contained in the ISDA Agreements;
- it made its own decision to enter into the agreement and any transactions; and
- it is capable of understanding and understands and accepts the risks.

Each transaction between CCM and the plaintiffs was specified in written confirmation and each was governed by and became part of each of the ISDA Agreements.

CCM and the plaintiffs engaged in numerous derivatives transactions over the years, some of which resulted in payments to CCM and some of which resulted in payments to the plaintiffs. In early October 2008, the dollar rose dramatically against the peso which increased the plaintiffs' mark-to-market exposure under the ISDA Agreements. Accordingly, each of the plaintiffs demanded that CCM post additional collateral. CCM did not do so, which constituted an Event of Default under each of the ISDA Agreements. On October 9, 2008, CCM filed a voluntary insolvency petition on Mexico, which was another Event of Default. Each of the plaintiffs elected to declare an Early Termination Date based on one or more of the Events of Default and, subsequently, liquidated each of the outstanding transactions under the ISDA Agreements and commenced the actions against CCM.

Since contract interpretation is a matter of law, Justice Bransten held that summary judgment is appropriate where the terms of the contract are clear and unambiguous and, relying on *Citibank, N.A. v. Plapinger*, 66 N.Y.2d 90, 93 (1985), "an affirmative defense is patently meritless." Justice Bransten held that each of the plaintiffs "clearly establish[ed]" the four elements of a breach of contract claim and, thus, CCM was liable for breaching the ISDA Agreements.

Justice Bransten then turned to CCM's affirmative defenses. The fraudulent and negligent misrepresentation defenses as well as the breach of fiduciary duty and aiding and abetting breach of fiduciary duty were held to fail as a matter of law based on the representations in the ISDA Agreements. CCM tried to escape that conclusion on the misrepresentation claims by arguing, among other things, that the plaintiffs had superior knowledge or the "special facts" facts doctrine applied to the alleged misrepresentations. Because CCM had engaged in derivatives transactions for over 15 years and the transaction confirmations set forth the details and risks, the superior knowledge defense failed. The "special facts" doctrine did not apply because the information was available to CCM. CCM's deceptive acts or practices counterclaim under Section 349 of the General Business Law also failed because the court held that the conduct was not consumer-oriented because the transactions were between sophisticated entities with substantial prior experience in derivatives transactions. Further, the court cited a number of cases that rejected attempts to apply Section 349 to securities or other financial transactions. Justice Bransten also rejected CCM's defense of failure to mitigate damages because each of the plaintiffs did exactly what the ISDA Agreements specified to do in the event of an early

termination.

The most interesting discussion in Justice Bransten's opinions relates to CCM's affirmative defense that the transactions were illegal and unenforceable under Mexican law. In determining whether a transaction illegality is a viable defense, New York law looks to the law of the situs where the alleged illegal act is done to determine if the act was illegal and then courts look to the law selected for conflicts analysis to determine the effect of any such illegality. Since the ISDA Agreements provided that they were governed by New York law, even if the transactions were illegal under Mexican law, New York law governs whether CCM was liable.

Relying on *Korea Life Ins. Co., Ltd. v. Morgan Guar. Trust Co. of N.Y.*, 269 F. Supp. 2d 424 (S.D.N.Y. 2003), Justice Bransten observed that there are two types of illegal contracts — *malum in se* (wrong by itself because it is immoral) and *malum prohibitum* (wrong because it is prohibited by law), the former being unenforceable and voided and the latter could be voided if either the contract was still executory or the both parties are not *in pari delicto* (at equal fault). CCM did not contend that the ISDA Agreements and the transactions were *malum in se*, but rather that the transactions were still executory and CCM was innocent of any violations of Mexican law. Justice Bransten held that the contracts were not executory because obligations to pay money in the future do not make a contract executory, the plaintiffs fully performed, and the plaintiffs terminated the ISDA Agreements. The court held that CCM was *in pari delicto* because: (1) the ISDA Agreements contained representations by CCM that it (a) had the power to enter into the transactions, (b) understood the transactions, and (c) did not violate any law applicable to it; (2) CCM had as much, or more, familiarity with Mexican law than the plaintiffs; and (3) CCM had engaged in derivatives transactions for many years and was a sophisticated entity. Accordingly, Justice Bransten held that the ISDA Agreements were enforceable even if they were illegal under Mexican law, a point never addressed in the opinion.

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