

Swaps, restitution and trusts

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*This book was based on my book *The Law on Financial Derivatives* and my doctoral research: it deals with the impact of the local authority swaps cases on derivatives market practice. The published version suffered from a very young editorial assistant working on her first book failing to transfer my hand-written changes from the proofs to the published version of the book. This was a great shame given the detailed, technical nature of the book and a great lesson. On this web page I have reproduced my original computer files for the abstract, preface, the opening portion of the Introduction and the contents for this book which gives an idea of the thesis of the work.*

Abstract

The book analyses the case of *Westdeutsche Landesbank v. Islington L.B.C.* and its ramifications for the swaps markets. In particular the book advances the thesis that claims in relation to restitution of money arising in relation to financial transactions ought to be founded on a notion of suitability. Further, the book highlights three key issues arising from the *Islington* litigation. First, that the courts failed to take into account the nature of swaps and their necessary allocation of risks between counterparties. Second, the problems created for the law of restitution by English law's conception of money as tangible property rather than as intangible choses in action held in electronic accounts. Third, the problem of taking security in financial transactions as a result of the decision of the House of Lords and by using standard market contracts as currently constituted. The underlying theme of the book is the conflict between the attitudes of traditional trusts lawyers and the proponents of the emerging principle of restitution of unjust enrichment. The book sets out new models for problems of equitable proprietary claims and unjust enrichment claims based on suitability for future cases, based on existing caselaw and by employing other techniques such as common intention constructive trusts, the doctrine of severance and the doctrine of undue influence.

Preface

The author has worked in the derivatives markets as legal counsel and as a finance professional, retaining a particular interest in the law of restitution. In that time the author developed the view that existing private law rules relating to financial transactions did not meet the particular circumstance of commercial transactions nor did it accord closely with established regulatory principles such as suitability. This book therefore seeks to

analyse the *Westdeutsche Landesbank v. Islington* litigation, together with the other local authority swaps cases, insofar as they impact on these issues.

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Introduction

This book is sustained principally by the analysis of one decided case concerning financial derivatives: *Westdeutsche Landesbank Girozentrale v. Islington L.B.C.*¹ (hereafter "*Islington*"). This is perhaps the most difficult of the decided local authority swaps cases dealing with the restitution of money passed under a contract subsequently found to have been void *ab initio* and the availability of compound interest in such circumstances.² The structure of the book is to consider first the nature of financial derivatives, second the legal analysis of financial derivatives, third the specific context of the 'local authority swaps cases', fourth the attitude of the High Court and Court of Appeal to the issues raised in *Islington*, and fifth the various approaches adopted by the members of the House of Lords in *Islington*. Finally, this book considers the development

¹ [1996] 1 A.C. 669, [1996] 2 W.L.R. 802, [1996] 2 All E.R. 961.

² The decided cases encompass a number of issues ranging from the capacity of local authorities, to issues surrounding the Gaming Act and restitution of money. The principal cases are: *Hazell v. Hammersmith & Fulham* [1991] 1 All E.R. 545, HL; *Westdeutsche Landesbank Girozentrale v. Islington L.B.C.* [1994] 4 All E.R. 890, Hobhouse J., CA; and reversed on appeal [1996] AC 669, HL.; *Kleinwort Benson v. Sandwell Borough Council* [1994] 4 All E.R. 890, Hobhouse J.; *Kleinwort Benson v. Birmingham City Council* [1996] 4 All E.R. 733, CA, on appeal from Gatehouse J., (unreported); *Kleinwort Benson v. South Tyneside M.B.C.* [1994] 4 All E.R. 972, Hobhouse J.; and *Morgan Grenfell v. Welwyn Hatfield DC and others* [1995] 1 All E.R. 1, Hobhouse J.; *Credit Suisse v. Allerdale B.C.* [1997] Q.B. 306; *Kleinwort Benson v. Glasgow C.C.* [1997] 4 All E.R. 641.

of the law of restitution in these commercial contexts and suggests a new model approach for effecting restitution of money and other property in the context of financial transactions.

The argument

The central contention of this book is that it impossible for parties to retain a proprietary interest in property transferred under a commercial contract which is found to be void *ab initio*, as a result of the majority decisions in the House of Lords in *Islington*. The restatement of the core rules of equity in the speech of Lord Browne-Wilkinson in *Islington*³ have created a test for the allocation of equitable title in property which is based solely on the conscience of the defendant to any claim. It is submitted that this concentration on knowledge of a factor which ought to affect a person's conscience is not the most appropriate mechanism for allocating personal and proprietary claims in the context of commercial and financial transactions. In particular, Lord Browne-Wilkinson held that a proprietary remedy will only be imposed in circumstances where the defendant has knowledge of the factor which is alleged to impose the office of trustee on him as opposed to strict liability.⁴ It is submitted that these principles restrict the potential intervention of equity to such a narrow range of cases that the mutual intentions of parties to commercial contracts will frequently not be enforced by either the rules of common law or of equity.

The core of this argument, as developed below, is that the courts' failure to enforce the credit enhancement and risk allocation provisions of the contracts and standard form agreements between the commercial parties to the swaps contracts, produced inequitable results between those parties, circumscribed the efficacy of English law in the context of financial agreements, and introduced further risk to financial markets by rendering otiose the terms of those standard form agreements.

In the context of financial derivatives contracts, it was the expectation of the parties that, even if their agreements should have proved to be unenforceable in whole or in part, the contractual terms of those agreements would regulate the manner in which unperformed, part-performed and executed contracts should be unwound.⁵ The failure of equity to give effect to those expectations introduces further uncertainty to commercial contracts by displacing the parties' previous understanding of their agreement. In effect, the commercial context of financial derivatives became the battleground for an ideological conflict between the rules of equity and the emerging principles of restitution.⁶

³ [1996] 1 A.C. 669, 698 *et seq.*

⁴ Birks, 'The Burden on the Bank', in Rose ed., *Restitution and Banking Law*, (Mansfield Press, 1998), 189.

⁵ International Swaps and Derivatives Association, *ISDA Multicurrency Master Agreement 1992* (New York & London, ISDA, 1992); and British Bankers Association, *British Bankers Association Interest Rate Swap Terms*, (London, BBA, 1987).

⁶ Birks, 'Trusts raised to avoid unjust enrichment: the *Westdeutsche* Case' [1996] R.L.R. 3.

The swaps cases have been broadly interpreted by many of the commentators as a conflict between the codes of equity and the emerging law of restitution.⁷ Indeed, this was the attitude of Lord Browne-Wilkinson to the issues argued in front of him.⁸ However, these analyses have failed to consider the impact of these decisions for the banking lawyer. Aside from the, admittedly important, issues of equitable proprietary claims and claims for restitution of unjust enrichment, are more general issues which impact on commercial parties of the effectiveness of market standard contracts, the entitlement to specified property under collateral agreements and physically-settled transactions, and the availability of compound interest in cash-settled transactions. For the derivatives lawyer, and anyone using the ISDA Master Agreement⁹ or the BBAIRS terms for interest rate swaps¹⁰ and other financial derivatives products, the impact of the swaps litigation remains problematic.

The core concern of this book, aside from examining the courts' approaches to the local authority swaps cases, is to consider the appropriate principles for effecting restitution of amounts paid under financial transactions. The book contrasts traditional equity and trusts law principles with the more progressive field of restitution of unjust enrichment and restitution for wrongs in the context of the local authority swaps cases.¹¹

The thesis in outline

The commonplace use of standard market contracts, particularly in the area of financial derivatives, sought to remove uncertainty and to control systemic risk by standardising the terms of over-the-counter agreements. As considered in *The Structure of Financial Derivatives Products* below,¹² the derivatives markets have sought to minimise the most serious risks facing their US\$50 trillion marketplace¹³ by standardising the manner in which those risks are allocated and managed in legal documentation. Among these risk management terms are provisions for the termination of contracts in a manner which reduces the systemic effect of payments being required immediately and in gross amounts, while also reducing the immediate financial pressure on the parties to a contract on the happening of one of the termination events specified in the contract. In the

⁷ *Ibid.*

⁸ [1996] A.C. 669, 708, considering Birks, 'Restitution and Resulting Trusts', in *Equity: Contemporary Legal Developments*, ed. Goldstein, (Jerusalem, 1992), 335. These issues are considered below in greater detail in *Conflicts between Traditional Equity and the Law of Restitution*, chapter 7.

⁹ International Swaps and Derivatives Association, *ISDA Multicurrency Master Agreement 1992* (New York & London, ISDA, 1992).

¹⁰ British Bankers Association, *British Bankers Association Interest Rate Swap Terms*, (London, BBA, 1987), which are expressed as taking effect between parties contracting interest rate swaps in London without need to include the terms explicitly in any contractual agreement.

¹¹ As to the nature of restitution in this context see Birks, "Misnomer", in Cornish, Nolan, O'Sullivan and Virgo, eds., *Restitution, Present and Future: Essays in Honour of Gareth Jones* (Oxford, Hart Publishing, 1998), 1; and the rejoinder by Tettenborn, "Misnomer: A Response", in Cornish, Nolan, O'Sullivan and Virgo, eds., *op cit.*, 31.

¹² Chapter 2.

¹³ As estimated by the International Swaps and Derivatives Association ("ISDA"), *ISDA News*, December 1997.

application of the ultra vires principle in the case of local authorities seeking to contract interest rate swaps,¹⁴ the English courts have chosen to consider these contracts to be simply unenforceable *ab initio*: as though they had never existed. As a result, the markets' attempts to introduce effective, consensual, ad hoc regulation by standardised documentation and market practices of the derivatives markets¹⁵ have been rendered ineffective. The issues considered in this book revolve around the ramifications of this joint application of the ultra vires rule and traditional principles of equity in relation to proprietary rights for commercial parties acting in global financial markets.

It is submitted that there should be created a separate stream of principles to give effect to the underlying aims of equity and common law with the need to effect restitution in the context of financial transactions such as those in the swaps cases. Specifically in the context of commercial standard form contracts, this goal would be best achieved by means of the development of equitable and common law principles based upon the express allocation of risk between commercial parties and the "suitability" of the financial transactions entered into between them. It is contended that the use of these principles, in the manner set out below in the 'suitability approach',¹⁶ would give effect to the broader, desirable policies of providing certainty in financial contracts, reducing systemic risk, and preventing the indirect enforcement of unsuitable financial contracts.

The English principles of Equity were formulated primarily to regulate the conduct of family trusts and rights in homes from the eighteenth century and beyond. The norms which were created in respect of the availability of proprietary rights and compound interest were orientated around domestic, factual situations. As Lord Browne-Wilkinson himself pointed out in *Target Holdings v. Redferns*,¹⁷ those 'traditional trusts rules' sit uncomfortably with the complex, cross-border markets of the late twentieth century.

In moulding the principles of equity, it is important to recognise context. The development of equitable principles in relation to commercial transactions has seen a greater 'concretisation' of the tests used by the courts and a movement away from the application of general principle to this context. Recent cases, such as *Royal Brunei Airlines Sdn Bhd v. Tan*¹⁸ and *Islington*, have typified a judicial desire to impose stricter rules on the nature of equitable responses than are suggested by the list of core equitable principles reproduced in *Snell's Principles of Equity*¹⁹ where vaguely poetic and normative prescriptions such as 'coming to Equity with clean hands' have long formed the lifeblood of the equitable counter-point to the rigours of the common law. Indeed, areas of the common law such as the tort of negligence have seen an ever greater relaxation of principles, as indicated by cases such as *Caparro v. Dickman*²⁰ and rules as

¹⁴ *Hazell v. Hammersmith & Fulham L.B.C.* [1992] 2 A.C. 1, [1991] 2 W.L.R. 372, [1991] 1 All E.R. 545.

¹⁵ This development has been primarily in the form of the ISDA standard form master agreement, International Swaps and Derivatives Association, *ISDA Multicurrency Master Agreement 1992* (New York & London, ISDA, 1992).

¹⁶ Set out in chapter 12, *Suitability - a new model?*

¹⁷ [1996] 1 A.C. 421, [1995] 3 W.L.R. 352, [1995] 3 All E.R. 785.

¹⁸ [1995] 2 A.C. 378, [1995] 3 W.L.R. 64, [1995] 3 All E.R. 64, [1995] 3 All E.R. 97, PC.

¹⁹ Baker and Langan, *Snell's Principles of Equity*, 29th edn., (London, Sweet & Maxwell, 1990).

²⁰ [1990] 2 A.C. 605.

the common law and equity appear to be moving in opposite directions. The question arises then as to the need to re-frame some of these equitable remedies such as knowing receipt and dishonest assistance in terms of strict liability.²¹

The further development is the growth of adherents to the principle of restitution of unjust enrichment among the commentators, to the chagrin of traditional equity lawyers. The stage was set in *Islington* for disagreement between the progenitor of the modern law of restitution, Lord Goff, and the new equity lawyer's broom of Lord Browne-Wilkinson. These two had taken different approaches to the appropriate use of equity and of trusts implied by law in decisions such as *Tinsley v. Milligan*.²² The notion of a law based on reversing unjust enrichment has been developed by Birks in a number of publications.²³ Indeed, his work is considered in close detail by the House of Lords in determining which ideological route is to be favoured in deciding the swaps cases. Much of the later discussion in this book takes up the threads of these distinctions and segregates them out into a series of different "approaches" to factual circumstances such as those raised by *Islington*.²⁴ The approach of Lord Browne-Wilkinson was to apply the traditional law of trusts, whereas the unjust enrichment lawyers have developed a new approach set out in the *radical restitution approach* in Chapter 11.²⁵

Birks has referred to there being little difference between the speeches of Lords Goff and Browne-Wilkinson in the interpretation of the equitable and restitutionary techniques available in *Islington*.²⁶ Indeed, Birks is somewhat dismissive of the extent of any change to the law of restitution introduced by Lord Browne-Wilkinson.²⁷ It is submitted, however, that the opposed speeches in *Islington* should be seen as the battleground for three factions of lawyers to consider the position of equitable proprietary remedies. Their various approaches to the problem at hand are symptomatic of their factional attitudes.

The first approach to the issues appealed to the House of Lords is identified as being a conservative '*restitution approach*' as set out in the speech of Lord Goff.²⁸ Strictly speaking Lord Goff's dissent is only partial - he dissents only on the question whether or not compound interest should be made available deciding that it should provide justice between the bank and the local authority. Lord Goff preserved the approach of the classical restitution lawyer in looking at problems of restitution of mistaken payments from the analysis of existing precedent and the need to achieve a 'just result' by means of reversing unjust enrichment.²⁹

²¹ See, for example, Smith, 'Tracing and Electronic Funds Transfer', in Rose ed., *Restitution and Banking Law* (Oxford, Mansfield Press, 1998), 120, 125; Birks, 'Equity in the Modern Law: An Exercise in Taxonomy' (1996) 26 U.W.A.L.R. 1, 72.

²² [1994] 1 A.C. 340, [1993] 3 W.L.R. 126, [1993] 3 All E.R. 65.

²³ Beginning with *Introduction to the Law of Restitution* (Oxford, 1989).

²⁴ See in particular chapters 7, 8 and 9.

²⁵ *The emerging principle of unjust enrichment*.

²⁶ Birks, 'Trusts raised to avoid unjust enrichment: the Westdeutsche Case' [1996] R.L.R. 3.

²⁷ Birks, 'Trusts raised to avoid unjust enrichment: the Westdeutsche Case' [1996] R.L.R. 3.

²⁸ This is considered below in the '*Restitutionary Approach*'.

²⁹ [1996] A.C. 669, 695.

The second approach, the ‘*equity approach*’, is a modern trusts lawyer’s view propounded by Lord Browne-Wilkinson’s leading speech. Contrary to Lord Goff’s imprecation that the appeal was not the opportunity to re-structure the conceptual underpinnings of the applicable principles of equity and restitution,³⁰ Lord Browne-Wilkinson decided to undertake exactly such an exercise of revision and ideological restructuring.³¹ As a result of his lordship’s extensive coverage, the nature and availability of resulting trusts is limited and the availability of proprietary remedies under constructive trusts is re-drawn. Lord Browne-Wilkinson began his judgement with a quasi-legislative account of the ‘relevant principles of trusts law’.³² This passage in the speech is ‘quasi-legislative’ in that it seeks to reform (or clarify, according to your view of the older precedents) the basis upon which trusts law operates. The detail of these fundamental principles is considered in greater detail below in *The Primacy of Equity*.³³ However, at this juncture it is necessary to stress simply that the new code is both purportedly comprehensive in its account of the basics of trusts law and controversial in the detail of some of its revision.³⁴

The third approach is dubbed in this book a ‘*commercial common sense approach*’ and was exemplified by the partially dissenting speech of Lord Woolf, finding some support in the speech of Lord Goff. This approach typified the attitude of a commercial lawyer seeking to isolate the way in which equitable remedies were, and ought to have been, available in commercial situations. It asserted that the expectations of commercial people ought to have been reflected in the principles which the courts will apply in cases like the interest rate swap litigation.

As mentioned above, this book identifies two further, extra-judicial approaches. The fourth approach then is the ‘*radical restitutionary approach*’ which is typified by the work of Birks,³⁵ Chambers,³⁶ Smith,³⁷ and Mitchell³⁸ as set out below.³⁹ This approach identifies as its core principle effecting restitution of unjust enrichment by subtraction of that enrichment. Much of this academic discussion is considered expressly by their lordships in *Islington* - for the most part this radical approach fared badly before the House of Lords, a fact acknowledged by Birks himself, insofar as it proposed the use of resulting trusts to achieve restitution.⁴⁰ The House of Lords instead favoured the approach taken by Swadling which propounded a more conservative use of constructive trusts.⁴¹

³⁰ [1996] A.C. 669, 682.

³¹ [1996] A.C. 669, 705 *et seq.*

³² *Ibid.*

³³ Chapter 10 below.

³⁴ [1996] A.C. 669, 705 *et seq.*

³⁵ Principally Birks, *Introduction to the Law of Restitution*, (Oxford, 1989).

³⁶ Chambers, *Resulting Trusts*, (Oxford, 1997).

³⁷ Smith, *The Law of Tracing*, (Oxford, 1997).

³⁸ Mitchell, *The Law of Subrogation*, (Oxford, 1994).

³⁹ Chapter 9.

⁴⁰ Birks, ‘Trusts raised to avoid unjust enrichment: the Westdeutsche Case’ [1996] R.L.R. 3, 15.

⁴¹ Swadling, ‘A New Role for Resulting Trusts?’, (1996) 16 L.S. 110, esp. 124-125, considering *Ayers v. South Australian Banking Co.* (1871) L.R. 3 P.C. 548.

The thesis which underpins this book makes up the fifth approach and is dubbed the 'suitability approach'. This approach is a fusion of existing common law, equitable and generally restitutionary principles, some of which were not considered by the courts in *Islington*, and is also based on a close analysis of the true nature of financial derivatives (both in general and specifically of the type considered in the swaps cases). The fundamental premise of the fifth approach is that broader policy considerations require the development a code of equitable and restitutionary principles which observe the contractual intentions of commercial parties, particularly where those contractual arrangements are based upon standard market contracts dealing both with the management of general systemic risk and specific risks between the parties. It is contended that standard market contracts for over-the-counter derivatives transactions seek to standardise and manage risk. Recent caselaw has identified the need to develop principles which are capable of dealing with modern commercial transactions.⁴² It is submitted that three particular areas demanding such evolution of principle are the allocation of rights in property dealt with by commercial parties, the creation of credit support contracts,⁴³ and agreements as to the allocation of specific commercial risks between parties.

The book proceeds on the basis that the decided cases have not analysed swaps contracts in the way in which their substance demands that they be considered.⁴⁴ The adoption of an implied understanding of a swap as being a single, executory contract⁴⁵ rather than an amalgam of separate payment obligations has led the courts to treat all swaps as capable of simple rescission and restitution by payment of money and simple interest. Further, the courts have considered all swaps to be identical transactions even though the substance of each contract was materially different.⁴⁶ For the rapidly developing derivatives markets, these unsophisticated analyses of complex, idiosyncratic transactions will continue to hamper the availability of proprietary rights, credit support and other risk management techniques in future cases.

Indeed, the nature of the property at issue as money held in electronic bank accounts⁴⁷ is not considered at all by the courts.⁴⁸ As considered below in *The Concept of Money*,⁴⁹ the understanding of the property at issue as being a series of mutual obligations manifested by complex choses in action would require a different approach to that taken by the courts in the swaps cases. Similarly, the provision for set-off of reciprocally-owed

⁴² See Lord Browne-Wilkinson in *Target Holdings v. Redferns* [1996] 1 A.C. 421, [1995] 3 W.L.R. 352, [1995] 3 All E.R. 785.

⁴³ Such as guarantees, mark-to-market collateral agreements and other mechanisms considered below in *Problems of Credit and Security* in chapter 4, *Issues of Finance and Law*.

⁴⁴ This issue is considered in detail in *Swaps Pricing Models* below.

⁴⁵ An analysis preferred in older cases concerned with foreign exchange contracts: *Re British Continental Bank* (1922) 2 Ch. 575; *Lisser & Rosencranz's Claim* (1923) 1 Ch. 976; *Bank of India v. Patel* (1982) 1 Lloyd's Rep. 506.

⁴⁶ For example in *Kleinwort Benson v. Sandwell B.C.* [1994] 4 All E.R. 890, Hobhouse J., and *Guinness Mahon v. Kensington & Chelsea R.L.B.C.* [1998] 2 All E.R. 272.

⁴⁷ Considered below under *The Concept of Money* in chapter 4, *Issues of Finance and Law*.

⁴⁸ Smith, 'Tracing and Electronic Funds Transfer', in Rose ed., *Restitution and Banking Law* (Oxford, Mansfield Press, 1998), 120.

⁴⁹ *Ibid.*

payments on each swap payment date and provision for set-off in the event of bankruptcy were not taken into account in considering the contingent nature of those choses in action. Consequently, the issue as to availability of proprietary rights over such choses in action and of compound interest of such value is not related to the nature of the modern financial world beyond English law's attachment to the concept of money as a tangible item of property.

Further, this book considers the detailed structure of swaps and other derivatives products from their inception (in their modern form) in the early 1980's cross-currency swap and parallel loan swap structures, to the use of credit derivatives and complex equity swaps in the late 1990's. At the core of the formation of a swaps transaction is a pricing mechanism which is built on costing the cash flow which makes up each individual payment obligation. Swaps are subject to a segmental analysis of their structure rather than being taken as a single executory contract which is provided by the seller for a one-off fee. That is, the seller will fix a price as though selling each individual payment obligation as a separate contract. The final price for the swap is the aggregate of those separate prices for each payment. As such a swap is, in essence, more akin to a series of financial forwards⁵⁰ or options than to the single, executory contract envisaged by Woolf LJ⁵¹ and Lord Templeman in *Hazell* as set out immediately below.⁵²

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⁵⁰ As defined in more detail below in *The Structure of Financial Derivatives Products*, chapter 2; see also *Swaps and Derivative Financing*, Satyajit Das, 2nd ed. (Irwin, 1994), 14-17.

⁵¹ [1990] 2 Q.B. 697, 739; [1990] 3 All E.R. 33, 63.

⁵² *Hazell v. Hammersmith & Fulham L.B.C.* [1992] 2 A.C. 1, [1991] 2 W.L.R. 372, [1991] 1 All E.R. 545.