Close-out netting and taking security in financial market contracts

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There are two primary considerations for lawyers in creating financial market transactions: the ability to set-off on insolvency of the counterparty and the general efficacy of termination provisions. This article considers the growth of recent caselaw in this area and the impact of recent House of Lords decisions on the efficacy of financial contracts. Of particular interest is the impact of the swaps cases *Westdeutsche Landesbank v. Islington*[1] and *Kleinwort Benson v. Glasgow City Council*[2] on the contractual and restitutionary effect of void contracts, and the decisions in *Morris v. Rayner Entreprises Inc.*[3] and *Re Bank of Credit and Commerce International SA (No.8)*[4] on the availability of set-off in case of insolvency. Each is considered in turn.

In the recent decision of the House of Lords in *Morris v. Rayner Entreprises Inc.*[5], Lord Hoffmann, delivering the only speech, sought to uphold commercial practice where it does not offend against public policy. Rather 'the law is fashioned to suit the practicalities of life and legal concepts like 'proprietary interest' and 'charge' are no more labels given to clusters of related and self-consistent rules of law.' In the context of financial derivatives, the decisions in the swaps cases have led to the overturning of the legal efficacy of a number of established, prudent market practices set out in standard documentation. The availability of netting of obligations and the organisation of proprietary rights in property by means of contract and credit support documentation.

The dire impact of the 'swaps cases' on financial markets has not been fully appreciated in the reams of academic commentary which has followed them. At the root of this concern is the attitude of the courts in finding implicitly that standard market contracts will be completely ineffective for risk management purposes where their economic terms have been held to be void or otherwise unenforceable.

First, it is important to consider the potential application of set-off provisions both during effective contracts and on their termination. Second, this article will consider the denial of any efficacy of those same contracts and the impossibility of asserting proprietary rights in connection with them.

The context in which set-off provisions, allocation of risk provisions and retention of title provisions are created is the minimisation of systemic and other risk in unregulated financial markets. Where courts refuse to enforce prudent self-regulation established

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[1] [1996] A.C. 669.
[2] [1997] 4 All E.R. 641.
[3] 30th October 1997 (unreported).
[4] [1997] 4 All E.R. 568.
[5] 30th October 1997 (unreported).

between commercial people, by development of applicable principle rather than by specific decision, the courts introduce further risk into volatile financial markets.

1. Set-off

Set-off arises in two distinct situations for the derivatives lawyer. The first is in the context of payment netting, the second in the context of close-out netting.

Payment netting concerns the ability of parties to set-off amounts owed reciprocally in financial transactions. The standard provision for payment netting in the International Swaps and Derivatives Association ('ISDA') 1992 Multicurrency Master Agreement provides that amounts shall be set off across potentially all forms of derivative transactions entered into between the same contracting parties. Usually this form of set-off will be restricted to transactions in the same currency although the only restriction on that provision in its market usage is the ability of the counterparties' electronic systems to cope with the demands of netting on that scale.

That this form of set-off by contractual agreement is permissible is not surprising. In the context of interest rate swaps, it was considered lawful by all courts in the *Westdeutsche Landesbank v. Islington* litigation.[6] While we are not given any of the detailed terms of the contracts, we are told that 'the contract only imposes a liability to pay net sums and that was all that was actually paid.'[7] This tells us that payment netting was in place between the parties.[8] That is, while the floating rate and fixed rate payers owed each other amounts in gross on the same date, the contracts provided that only the party owing more that it was owed should pay a net amount equal to that surplus to the other party.

This use of payment netting is a significant part of structuring this interest rate swap. Only one payment is ever actually made although two amounts are owed. It is therefore possible that on some occasions no surplus amount will be owed where the gross obligations set off exactly. The manner in which this interest rate swap was priced meant that it would have required a large movement in sterling interest rates to achieve that result.

The second type of set-off, close-out netting, is the ability of set off amounts owed reciprocally on the insolvency of one of the parties.

Set-off on insolvency

[6] [1996] A.C. 669.
[7] [1994] 4 All E.R. 890, 905, Hobhouse J.
[8] It is important to distinguish 'payment netting' during the life of transactions from 'close-out netting' which occurs on the termination of the contractual agreement between the parties on bankruptcy or the happening of some other event of termination.

The insolvency context in over-the-counter derivatives

The most vexed issue in the insolvency context for the derivatives lawyer has been the feasibility of relying on contractual provisions to effect close-out netting.[9] The issue under the executory contract approach is whether or not liquidators are entitled to 'cherry-pick' contracts which are in-the-money for the insolvent entity, while repudiating simultaneously those contracts which will generate a loss.[10] There is a difficulty with seeking to close-out contracts which remain executory or requiring the creation of reverse transactions.[11] It is accepted that there is no difficulty in consolidating amounts owed so as to generate a single sum which is required to be exchanged between the parties. Complications arise where matured obligations are to be paid between the parties. In the context of swaps, matured obligations would appear to include periodical amounts where the reset date has been reached.

The term 'set-off' is considered in a number of authorities. The Court of Appeal were required to consider that term in the context of cross-claims and set-off under s.28 of the Limitation Act 1939: thus 'legal set-off'. Lord Denning MR held:-

> 'These cross-claims must arise out of separate transactions[12] [i]f there is no separate transaction, but only opposing demands arising out *of the same transaction*, then no question of set-off, properly so called, arises.'[13] [his lordship's emphasis]

Hobhouse J., however, disagreed with the interpretation set out by Lord Denning in the context of a statute bar to a claim of set-off in respect of the first swap contract at issue in *Kleinwort Benson v. Sandwell B.C.*.[14] The question then is, if that is the position with reference to legal set-off under statute, what is the position of equitable set-off? The discretionary nature of the defence of equitable set-off is seen clearly in *Hanak v. Green*[15]. The question with reference to set-off, in the opinion of Hobhouse J. is whether it is in accordance with equity on the facts of any particular case.[16]

With reference to the *Sandwell* case, the issue arose whether the transactions should be considered to be completely separate, or whether there was some nexus between the separate payments where they were made expressly in connection with one another. Thus, in the finding of Hobhouse J.:-

> 'Accordingly, the position was analogous to that of a running account between the two parties. Only one underlying transaction was involved - the first Sandwell swap contract. The successive payments merely altered the location

[9] See on this '*Principles of Corporate Insolvency Law*', 2nd edn., R. Goode (Sweet & Maxwell, 1997), 172-203; rule 4.90 of the Insolvency Rules 1986.
[10] See on this '*Principles of Corporate Insolvency Law*', 2nd edn., R. Goode (Sweet & Maxwell, 1997), 178.
[11] For example, of the type executed in *Sandwell*, discussed below.
[12] This returns to the core discussion of whether or not there are separate transactions in relation to payment netting.
[13] *Henriksens Rederi A/S v. PHZ Rolimpex* [1974] QB 233, 245.
[14] [1994] 4 All E.R. 890, 945.
[15] [1958] 2 QB 9.
[16] [1994] 4 All E.R. 890, 945.

> and extent of the enrichment which existed from time to time. The earlier payments had long since ceased to give any cause of action to either party. They were merely part of the previous dealings between the parties which were relevant to ascertaining what, if any, cause of action either party had at a later date.'[17]

There remains a central issue of analysing swap transactions: whether the agreements are to be seen as a single executory contract which cannot be considered fully performed until the last payment has been made, or whether swaps are to be seen as a series of distinct debts owed mutually between the parties on each reset date. The financial engineers creating interest rate swaps habitually employ a pricing model based on the cost of a series of separate forward transactions between the parties. The effect of the mutual debts approach is that there is full performance of each debt on each reset date.

The set-off provision in over-the-counter derivatives transactions is usually contained in the master agreement formed to regulate the whole of the derivatives business in all products and in all currencies between two parties. As such, set-off on termination of the trading of a derivatives book is sought across all products and not simply within the structure of a single contract. As identified at the outset, the risk of the potential unenforceability of this contractual term means that the ability of the parties to set-off is removed. As considered below, the absence of an effective set-off provision in the agreement would make set-off on insolvency impossible. The single agreement' approach identified in the standard form market agreements[18] potentially risks the possibility of *any form of set-off* where any part of the agreement is found to be ineffective.

In considering the 'executory contract analysis' or 'mutual debts analysis' dichotomy in the nature of the swaps contract, the issue arises whether there is a difference between the analyses in considering the set-off position. Hobhouse J. found the following facts in relation to the position where there were a number of inter-related payments but some were made outside the limitation period:-

> 'Where there have been a whole succession of payments one way and the other in respect of a single underlying transaction, both equity and justice require that one should have regard to the totality of those payments and the resultant overall benefit and detriment and not have regard to some arbitrary cut-off point (i.e.: in relation to the Limitation Act) unless there is some statutory provision which requires one to do so.'[19]

It is submitted that this passage does not provide an answer to the issue which of the two analyses has greater utility. What is does indicate is that it is preferable to consider the totality of the payments made between the parties, rather than to separate those payments. However, the separation of payments does not arise from some analysis of the structure involved but is concerned with some intervention of law.

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[17] [1994] 4 All E.R. 890, 941.
[18] See the ISDA 1992 Multicurrrency Master Agreement, section 1c.
[19] [1994] 4 All E.R. 890, 941.

Close-out netting

This issue of matured obligations arose in the House of Lords decision in *British Eagle International Airlines -v- Air France*[20] where it was held that the divestment of an insolvent's assets was against the spirit of the bankruptcy laws. That case involved a clearing house scheme whereby airlines would net amounts owed between themselves on a regular basis. British Eagle went into liquidation still owing amounts under that agreement. It was held by the majority that to uphold British Eagle's obligations under that contractual clearing house arrangement would be to the disadvantage of the airline's other creditors and would therefore infringe the *pari passu* rule.[21] The decision of the House of Lords in *British Eagle* therefore suggested that executory contracts may not be rescinded on the insolvency of a counterparty, even if there is a clause to that effect in the contract, and provided that no asset has been transferred under the contract from the insolvent party.[22]

However, an express clause similar to that typically found in a derivatives document providing for rescission, it is suggested, has been held to be valid.[23] In the absence of a rescission clause, the position of the liquidator with reference to undertaking to perform the contract would be different, as in *re Castle*[24]. In *Shipton Anderson & Co -v- Micks Lambert*,[25] a buyer's right to rescind a commodity contract was upheld when the seller ceased payment under an express termination clause. It was at this level that the derivatives community rested uneasily over the question of close-out netting.

The position in relation to the right of set-off in company liquidations has been made clearer by the decision of the House of Lords in *Stein v. Blake*[26] where the provisions of rule 4.90 of the Insolvency Rules 1986 were upheld as being mandatory in circumstances where there were mutual debts between the parties[27] created before the person asserting set-off had notice of the insolvency of the liquidated party.[28]

Rule 4.90 of the Insolvency Rules 1986 provides:-

> '(1) This rule applies where, before the company goes into liquidation there have been mutual credits, mutual debts or other mutual dealings between the company

[20] (1975) 2 AllER 390 HL
[21] Goode has criticised this decision for failing to observe the commercial expectations of the parties: '*Principles of Corporate Insolvency Law*', 2nd edn., R. Goode (Sweet & Maxwell, 1997), 182. In this, the House of Lords has acted similarly to *Westdeutsche Landesbank v. Islington L.B.C.* in imposing legal principle in a way which went against the parties' commercial understanding of their agreement.
[22] The only qualification to this argument, under the executory analysis, is that no asset must have passed under the contract to the insolvent.
[23] see for example *Ogdens -v- Nelson* [1905] AC 109
[24] (1917) 2 KB 725
[25] (1936) 2 All E.R. 1032
[26] [1996] 1 A.C. 243, *per* Lord Hoffmann; also the Court of Appeal in *MS Fashions Ltd. v. Bank of Credit and Commerce International S.A. (No.2)* [1993] Ch. 425, per Hoffmann J., affirmed at [1993] Ch. 439.
[27] *Bank of Credit and Commerce International S.A. v. Prince Fahd Bin Salaman Abdul Aziz Al-Saud* [1997] B.C.C. 63.
[28] *Stein v. Blake* [1996] 1 A.C. 243.

> and any creditor of the company proving or claiming to prove for a debt in the liquidation. (2) An account shall be taken of what is due from each party to the other in respect of the mutual dealings, and the sums due from one party shall be set off against the sums due from the other. (4) Only the balance (if any) of the account is provable in the liquidation, Alternatively (as the case may be) the amount shall be paid to the liquidator as part of the assets.'

The litigation in the wake of the BCCI collapse has generated a number of issues in relation to operation of set-off on insolvency. The decision of the House of Lords in *Morris v. Rayners Enterprises Incorporated*[29] considered rule 4.90 in the context of the ability of a borrower to seek to set-off its debt obligation to BCCI against a third party depositor with the bank. In particular this case concerned an attempt to use money in a tax efficient manner by borrowing on the security of a deposit, rather than simply using the money which constituted the deposit itself. In both joint appeals deposits were provided as security for loans to the respondent borrower.[30] The security documents purported to grant a proprietary interest in the deposit to BCCI by means of 'a lien or charge'. Further, the documents asserted that there was no prior pledge over the 'beneficial interest' in that deposit. Finally, the documents provided that the deposit would not be repayable to the depositor unless all of the liabilities of the borrower had been satisfied.

As Lord Hoffmann held in considering rule 4.90:-

> 'When the conditions of the rule are satisfied, a set-off is treated as having taken place automatically on the bankruptcy date. The original claims are extinguished and only the net balance remains owing one way or the other: *Stein v. Blake*. The effect is to allow the debt which the insolvent company owes to the creditor to be used as security for its debt to him. The creditor is exposed to insolvency risk only for the net balance.'

This rule is clearly restricted to English law transactions and cannot control the private international law problems created by conflicting codes of insolvency law.[31] As Lord Hoffmann continued, the availability of mutual set-off in these circumstances is restricted to claims between contracting parties and not to claims in respect of third parties, for fear that this would 'subvert the fundamental principle of pari passu' as established in *British Eagle*. On the facts of *Morris*, therefore, the separate legal personality of borrower and depositor could not be overlooked to give effect to set-off. As his lordship held:-

> '[The appellant] cannot manufacture a set-off by directing that the deposit be applied to discharge someone else's debt, even though it may, as between itself and the debtor, have a right to do so. This is the very type of arrangement which the House declared ineffective in *British Eagle*.'

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[29] 30th October 1997 (unreported).

[30] An argument was raised in the second appeal that the deposit had pre-existed the loan and therefore ought to be dealt with differently from the other appeal where the deposit was created as part of the lending transaction.

[31] See *In re Bank of Credit and Commerce International S.A. (No.10)* [1997] 2 W.L.R. 172.

Therefore, the set-off must be clearly operational between two contracting parties specifically and cannot benefit the obligations owed by some third party to that set-off arrangement. This may have implications for margin-credit agreements in the derivatives area, which are considered below.

More generally, the impact of this decision on cross default language is important. The ISDA form of cross-default considers defaults by a counterparty in the performance of a specific type of derivative transaction. In most situations, market participants widen this definition to include any acceleration of any debt-related or equity-related obligation of a counterparty or any associated entity specified as falling within the ambit of the provision. Where set-off is to be limited to obligations between contracting parties as a result of *Morris*, it would appear that the ISDA form of cross-default clause, expressed purportedly to take into account the obligations of parties who are not a party to the agreement, will not be able to take those obligations into account in calculating a final netted termination amount.[32]

Importantly for the cash-settled OTC derivatives markets, Lord Hoffmann is able to overcome the conceptual difficulty which founded the rule in *Re Charge Card Services Ltd.*[33] of taking a charge over a book debt held by the chargee. At one level Lord Hoffmann dismisses the much-vaunted conceptual impossibility as being founded on the idea of there being a lien over a book debt in these circumstances.[34] However, an equitable charge over property is considered by his lordship to grant the holder rights to resort to that property to satisfy some liability owed to it. This recourse can involve either the sale of an asset or the cancellation of some equity of redemption in respect of it. More particularly, a chose in action is accepted as being property capable of being the subject matter of a charge and therefore, it is said, there ought to be no problem with beneficiary of the charge being the debtor under that chose in action.

The resistance of the financial markets to seeking registration of charges in this context, considering that to be an unwelcome added cost of transacting, is subject to the proviso that charges granted by companies over book debts are registrable under ss. 395 and 396(1)(e) of the Companies Act 1985. In the context specifically of dealings with bank deposits, it is 'unlikely'[35] that there will be an obligation to register such charges.[36] This does not appear to remove the obligation to register charges created in connection with warrants over English companies. In the context of many equity derivative products, it is suggested, this problem may still be at large.

Specific OTC derivative situations

The arrangement in *Morris* mirrors many forms of derivatives credit support or margin-credit agreements where assets are pledged by Holding Co. to secure the performance of Subsidiary Co. in contracting derivatives with Seller. It is intended that title in property

[32] The standard ISDA wording expressly includes specified transactions and specified entities.
[33] [1987] Ch. 150.
[34] See for example *Haleowen Presswork & assemblies Ltd. v. National Westminster Ltd.* [1971] 1 Q.B. 1; [1972] A.C. 785, *per* Buckley L.J..
[35] *Per* Lord Hoffmann, op cit.
[36] *Northern Bank Ltd. v. Ross* [1990] BCC 883, *per* Lord Hutton.

will pass to Seller where Subsidiary Co. fails to perform. What is important is whether there is a collateral agreement between Holding Co. and Seller for the provision of security which is separate from the master agreement and confirmation between Seller and Subsidiary Co..

The widespread use of margin-credit arrangements in the over-the-counter derivatives market carries problems of set-off with it. Set-off under the master agreement has been considered above. What has not been considered is the ability of the parties to include the value of any margin-credit supplied within the scope of close-out netting. Seller should insist that property is transferred to Subsidiary Co. and that it is Subsidiary Co. which provides the credit support or margin-credit.

To maintain a tri-partite structure creates difficulty in respect of set-off between the two contracting parties and the credit support provider. The courts have shown their reluctance to see consequential losses associated with hedging transactions as being linked to losses arising from the main derivatives transaction in *Kleinwort Benson v. Birmingham C.C.*.[37] It is submitted that the same problems of establishing a nexus would obtain where Seller is seeking to enforce a set-off provision across the full range of derivatives contracted with Subsidiary Co., where only a part of that range of transactions is covered by the credit-margin or credit support agreement. This is despite the explicit assumption in the standard ISDA provision that close-out netting will take place across all derivatives transactions. The lack of contractual nexus would prevent such across-the-board netting being permitted.

Habitually the marketplace requires that the whole interest in any form of margin-credit is transferred to Seller with a contractual obligation to transfer to Subsidiary Co. the cash equivalent or assets equivalent to the margin-credit if all of Subsidiary Co.'s obligations are performed in full. Evidently this approach raises a number of commercial questions as to Subsidiary Co.'s willingness to transfer assets outright. Furthermore there are a number of issues as to the manner in which the assets forming the margin-credit are to be valued and the manner in which the outstanding derivatives transactions are to be marked-to-market before their maturity.

The issue is considered below whether or not proprietary claims to margin-credit arrangements will be available in all derivatives transactions.

Matured and unmatured obligations

In the context of unmatured obligations, it is submitted that the appropriate analysis is to look at those obligations as reaching maturity at the time when the company becomes insolvent. This approach appears to be in line with the principle that such unmatured debts be converted into matured debts available for set-off on liquidation.[38] It is further

[37] [1996] 4 All E.R. 733; noted by Hudson, *Amicus Curiae*, November 1997, 27.
[38] *MS Fashions Ltd. v. Bank of Credit and Commerce International S.A. (No.2)* [1993] Ch. 425, per Hoffmann J., affirmed at [1993] Ch. 439; see also '*Principles of Corporate Insolvency Law*', 2nd edn., R. Goode (Sweet & Maxwell, 1997), 195.

contended that where an unmatured debt is terminated by operation of some contractual provision, it is to be treated as matured as of the date applicable under that provision - whether the event of default is the counterparty's insolvency or some other cause. Thus, the use of termination events which terminate all transactions entered into between two parties, as with the ISDA Master Agreement, in themselves favour the application of the single contract approach.

The market standard form master agreements have the effect that, where the derivative instrument is properly analysable as a single executory contract, on the insolvent winding up of one of the parties, mutual executory contracts entered into before the insolvency petition can be terminated at market value. Where there is a provision in the master agreement to that effect, gains and losses on a series of terminated transactions can be set off - subject to the counterparty nexus required by *Morris*. The standard provisions in the ISDA form of Master Agreement will operate to allow for netting on insolvency where there are two-way payments. It is advisable, from an insolvency perspective, that there be a requirement for notice precipitating termination rather than automatic termination under an appropriate event of default in the Master Agreement. One of the difficulties with automatic termination is that of establishing the correct mechanics to calculate the appropriate netted amount to be paid as at the termination date.

The provisions in the ISDA Master Agreement will further provide for set-off on the insolvency of one of the parties to a derivative instrument which provides for a contingent debt: for example, cash-settled options, caps and floors. Where it is the seller of the instrument that goes into insolvency, the value of the claim under the contract will be available for set-off. Where it is the buyer of the instrument that goes into insolvency, it is likely that the value of the instrument at termination will be available for set-off. However, where the value at termination cannot be ascertained or accelerated, it is likely that set-off will still be available provided that the master agreement does not attempt to divest the seller of its obligations to make payments under the agreement. As above, it is preferable that there be two-way payments and that there be a requirement for notice before termination.

Specific performance is not available for cash-settled, executory contracts in most circumstances because damages will be an adequate remedy. In the case of an insolvent counterparty, specific performance would be an impossibility in most practical circumstances in any event. The tidier analysis from the insolvency point of view is the composite executory contract view. The mutual debts analysis imports complications of performed and unperformed, and separately enforceable obligations.

The appropriate remedy for a solvent party in the event of the repudiation by, or insolvency of, the counterparty is to rescind the contract. If the proper analysis of the derivatives contract is that it represented claims for debts both ways, then unquestionably the solvent party could not cancel its obligation to pay vested debts to the insolvent party and so full, reciprocal rescission would not be possible. However, in the event that the executory analysis is followed, rescission would be possible on the basis that the condition precedent to execution, had not been performed.

The peculiarities of the ISDA Master Agreement complicate the picture with reference to close-out netting. There are a number of provisions which are not specifically

recognised by English law. There is therefore a need to include a provision in the Master Agreement which provides for ineffective provisions to be deleted and for the remainder of the contract to continue in effect. The complication is clearly that a contract which has a part of its terms removed, will complicate the position as to rescission. Rescission in these circumstances is made simpler by the composite executory contract analysis because it makes calculation of the amounts to be repaid more straightforward. However, the incorporation of separate contracts into a single master agreement, makes it equally feasible to achieve rescission across the spread of swaps transactions.

The certainty of the netting position on swaps, collars, forwards and physically-settled options would be enhanced if full-two-way payments were adopted. In the case of caps, floors and cash-settled options, the adoption of full two-way payments is essential.

Set-off on termination of agreement between solvent parties

Set-off provisions will be called into play in situations other than on liquidation of one of the counterparties. The range of events terminating a master agreement include pre-liquidation events where there is no eventual liquidation, such as credit downgrades, and other impacts on the legality, efficacy or commercial viability of the transactions entered into under it. An executory, cash-settled derivatives contract is an agreement to exchange amounts of value between electronic accounts, under which the prime remedy of a willing party against a repudiating party is for damages equal to the contemplated loss suffered after exercise of the duty to mitigate. The measure of damages would often be any excess cost in replacing the contract in the market plus any special damages.[39] The damages may be pre-determined by liquidated damage clauses, such as those represented by the ISDA termination provisions, in accordance with normal contractual principles.

The appropriate remedy of a solvent party in the event of the repudiation by, or insolvency of, the counterparty is to rescind the contract. If the contract represented claims for debts both ways, then unquestionably the solvent party could not cancel its obligation to pay vested debts to the insolvent party and so full, reciprocal rescission would not be possible. In the event that the executory analysis is followed, rescission would be possible on the basis that the condition precedent to execution (completion of the transactions), had not been performed. This is the primary value of the executory analysis: it enables the parties to rescind across a wider section of payments. It is possible to exist from the totality of an agreement rather than relying on it being partially enforceable because it has been partly performed.

Where there is only a liability to make payment one way at the date of completion, due to set-off, the availability of reciprocity is altered and it may affect the suitability of rescission. At first blush, rescission is made simpler by the composite executory contract analysis because it makes calculation of the amounts to be repaid more straightforward.

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[39] The standard market contracts deal with situations like recovery of legal expenses (excluded under the ISDA code), the cost of unwinding hedges (generally held to be unenforceable by the Court of Appeal in *Kleinwort Benson v. Birmingham* [1996] 4 All E.R. 733), and the cost of replacement transactions.

However, the incorporation of separate contracts into a single master agreement, makes it equally feasible to achieve rescission across the spread of swaps transactions on the basis of the ISDA 'single contract approach' considered above.

2. *Effectiveness of the standard form contracts*

It is not suggested in the following that the decisions on the facts in the 'swaps cases' were wrong. Rather, that the principles upon which those decisions were reached, if pushed to their proximate and logical conclusions, have far-reaching implications which would be better avoided. The standard market contracts, considered below, are not adequate to rebut the conclusions of the English courts on their facts. Consequently, it is suggested that there are different principles which ought to be applied by equity in the context of commercial transactions to achieve the desirable result of systemic risk management and greater commercial certainty.

The problem with the decision in *Islington* and all of the other swaps cases is that the courts ignore the *fact* that the parties *had allocated the risks of their transactions*. Leggatt LJ considered that there was no substantive issue to consider on the facts of *Islington*, rather 'the parties believed that they were making an interest rate swaps contract. They were not, because such a contract was ultra vires the local authority. So that they made no contract at all.'[40] Therefore, despite the exhaustive documentation created between the parties, the courts made no reference at all to any of the contractual terms agreed between them. Precisely why there was no such reference is not made clear. At one level it would appear that no argument was raised by counsel as to the efficacy of the risk allocation provisions.

The terms of the contracts were considered to have been of no relevance because the authorities were held not to have been capable of entering into them at all in any event. As a result, it must be surmised in the absence of any express findings, it was considered appropriate to ignore any term within that contract on the basis that it had been found to be void. Logically this would include terms dealing with credit risk management, as well as terms dealing with the creation of commercial interest rate swap obligations.[41] No point was raised that set-off provisions were ultra vires the local authorities - simply that contracts establishing obligations to make interest rate swap payments were.

However, the further question arises: would a guarantee be valid if it were annexed to that contract. That is, would the banks have been able to enforce the terms of any guarantee extended to them by the local authorities? What is not clear is whether the preclusion on entering into interest rate swaps must also be binding on any guarantee collateral to that agreement.

If that were the case, it would follow that any credit support document or set-off provision attached to the interest rate swap agreement would be similarly void.

[40] [1994] 4 All E.R. 890, 967.
[41] On this, see *Suitability Approach*,*'Severance'* below.

Therefore, if the authorities had ring-fenced a particular bank account with an amount of money in it, held on a trust (within the terms of the swaps contract) for the banks contingent on the authorities' failure to perform under the main agreement, the banks would have had no recourse to that money. This would be despite the authorities' ability to pay amounts of money to banks acting at arm's length from them by way of interest or fees.

In considering whether or not proprietary claim ought to be available to Westdeutsche, Lord Goff said:-

> 'The immediate reaction must be - why should it? Take the present case. The parties have entered into a commercial transaction. The transaction has, for technical reasons, been held to be void from the beginning. Each party is entitled to recover its money, with the result that the balance must be repaid. But why should the plaintiff bank be given the additional benefits which flow from a proprietary claim, for example the benefit of achieving priority in the event of the defendant's insolvency?'

At this level is possible to say that a commercial party should only be entitled to recovery on the basis of a proprietary claim where there is some attempt to reserve to it some proprietary remedy. To repeat, it is not this writer's contention that proprietary rights should always be awarded to commercial parties entering into financial transactions. However, the following words of Lord Goff contribute to the conclusion that it is not clear how the banks *could* have taken proprietary rights in the swaps litigation:-

> 'After all, [Westdeutsche] has entered into a commercial transaction, and so taken the risk of the defendant's insolvency, just like the defendant's other creditors who have contracted with it, not to mention other creditors to whom the defendant may be liable to pay damages in tort.'[42]

The weakness with this reasoning is that Westdeutsche has not taken the risk of the authority's insolvency. Rather, it had sought to protect itself against the insolvency of the authority by means of the termination language in the contract and any credit support language it may have used. Given the mutual determination of Lord Goff and Lord Browne-Wilkinson that there was no ground for the banks having a proprietary interest in any property held by the local authorities, the logical conclusion of their reasoning is that there would have been *no way in which the banks could have reserved to themselves any proprietary interest in the money paid to the local authorities* because the contracts were simply not considered effective at all.

The 'swaps cases' concerned two forms of interest rate swap. The first was a deep discount swap in which a lump sum was paid by the bank to the local authority, as well as the usual payment of fixed and floating rate amounts between the parties, calculated by reference to a notional amount of money. The second was a vanilla interest rate swap providing for payments of fixed and floating amounts of interest, calculated by reference to a notional amount of money. Further to the decision of the House of Lords in *Hazell*

[42] [1996] 2 All E.R. 961, 968.

v. Hammersmith & Fulham,[43] these contracts were held to be ultra vires the local authorities and therefore void ab initio. The issue arose as to manner in which the banks were entitled to seek recovery of sums paid to the local authorities.

There is only one route left available to them. With reference first to the deep discount swaps, that route would have been for the banks to hold the deep discount amounts[44] paid by them on trust for themselves should the authority fail to perform. The authorities' ability to use the money to massage their rate-capped income position (the commercial purpose for the swap) would have been made complicated. It is difficult to see how there could have been retention of title where the contracts which would have contained that language were held to be void.

Stand-alone express trust structures appear to be the only reliable method to retain an equitable interest in property transferred. The parties would have had to enter into a stand-alone loan structure to allow the retention of title language to stand outwith the void swap documentation. However, that would simply have created an on-balance sheet, rate-capped loan which would have opened the authority up to surcharges thus destroying the commercial purpose of the transaction. Therefore, there would be no effective, commercial means for the banks to have retained title in the money which they paid over.

At the time when the intention to pass title in the money to the authority was formed, the issue arises what risks were accepted and appropriated between the parties. Avowedly, neither party took an unallocated risk that the other party would be unable to perform the agreement (as set out in the BBAIRS and ISDA terms above). However, their agreement provided only for the payment of net amount to unwind the transaction and did not provide for any specific retention of proprietary title in the property passed. Therefore, it is not proposed to consider the impact of the *Quistclose*[45] line of cases because there was no express retention of title as in those cases.

With reference to the vanilla interest rate swaps,[46] it would be simply impracticable to require that payments made under the periodic structure would be held on trust through the life of the agreement. The property forming the subject matter of that trust, value in electronic bank accounts, would be exhausted a number of times over thus removing all equitable tracing rights. To require a static trust would again defeat the parties' commercial purpose because the interest rate swap would be of no commercial efficacy at all. The use of language to create some charge over the property of the authority would similarly be void, annexed as it would be to the void interest rate swap contract.

Therefore, the practical commercial implications of the decision of the House of Lords is that it is impossible to retain title to any property or value passed in the conduct of a swap transaction which is subsequently found to be void. This result must indicate

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[43] [1992] 2 A.C. 1.
[44] In *Islington*.
[45] *Quistclose Investments Ltd v. Rolls Razor Ltd (in liquidation)* [1970] AC 567.
[46] In *Sandwell*.

that the rationale behind the decision cannot be the correct approach in commercial contexts. While it might be the better approach with reference to domestic mortgages, it is not appropriate with reference to sophisticated financial transactions.

Martin joins the camp of commentators who identify in the bank satisfaction that they would pass title in the deep discount payment absolutely to Islington 'and had been prepared to take the risk of insolvency'.[47] There was, of course, no intention to take that risk absent effective netting provisions. The result is that property in the money passes even though the contract is void. This efficacy of the contract would appear to be in support of the original purpose of the contract, rather than returning the full property in the money to the bank to negate the commercial effect of the transaction.

Severance

It is submitted that it would be possible to sever the termination provisions from the economic provisions of the swap contract. This contention proceeds on the basis that the latter provisions carry out the interest rate swap which was held to be ultra vires the local authority, whereas the termination provisions provide only a commercially effective means of rescission and contribute to a reduction in systemic risk in the financial markets.

The classic statement of the doctrine of severance is that: 'where you cannot sever the illegal from the legal part of a covenant, the contract is altogether void; but, where you can sever them, whether the illegality can be created by statute or by common law, you may reject the bad part and retain the good.'[48]

The decision of Megarry J. in *Spector v. Ageda* [49] held that the whole of the contract must be considered to be void even where a part only of the agreement had been found to be illegal by operation of statute. The policy identified in this decision was to prevent parties to illegal contracts from putting themselves into further harm by enforcing other contracts. Similarly, in *Esso Petroleum v. Harper's Garage (Stourport) Ltd.* [50] it was held that where covenants in a contract are so closely connected that they can be deemed to stand or fall together, the whole contract will fail even though some sections may appear to be severable.

The doctrine of severance might also apply with reference to the distinction between executed and non-executed transactions. It could be submitted that, where the parties have acted consensually, and without any other unjust factor such as fraud or undue influence, there is no injustice in requiring the parties to observe their agreement.[51]

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[47] Hanbury and Martin 'Modern Equity' (13th edition, Sweet & Maxwell, 1993), p.665.
[48] *Pickering v. Ilfracombe Railway* (1868) L.R. 3 C.P. 235, 250; *Payne v, Brecon Corporation* (1858) 3 H. & N. 572; Royal Exchange Assurance Corporation v. Siforsakrings Aktiebolaget Vega [1901] 2 K.B. 567, 573; *Chitty on Contracts,* 27th edn. (Sweet & Maxwell, 1994), para. 16-165.
[49] [1973] Ch 30.
[50] [1968] A.C. 269, 314, 321.
[51] There is a further issue as to the efficacy of collateral 'credit support agreements' which cannot be considered here due to lack of space. However, it appears that ISDA's current strategy with regard to

In the Court of Appeal in *Islington*, Dillon LJ held, considering *Rugg v. Minett*[52]

> 'I do not see why a similar process of severance should not be applied where what has happened, in a purely financial matter, is that there has been a payment of money one way and a payment of smaller sums of money the other way. The effect of severance is that there has been a total failure of consideration in respect of the balance of the money which has not come back.'[53]

One important issue arising in this context is why severance had not been similarly available with reference to the *Sandwell* litigation[54] where some of the contracts had been performed. The further issue is whether some of the payments made between the parties could be treated as settled (thus supporting a mutual debts analysis) or whether they are to be required as part of a single (executory) contract which had not been fully performed until the final payment had been made.[55]

The argument from risk

Financial markets create, manage and exploit risk: frequently at the same time. The role of the lawyer in that context is to be a risk manager. Legal risk management can be achieved in one of two ways. The first is by not entering into the market at all and thus avoiding any risk. The second is by creating contracts which seek to control those risks. Where these contracts are held to be void, the ability of the parties to control their risk portfolio is effectively removed. In unregulated financial markets, the role of commercial and property law is to support prudential and lawful attempts to manage risk.

The impact of ineffective standard market contracts is an increase in systemic risk. This form of risk was highlighted most recently by the collapse of Yamaichi Securities. Systemic risk is said to arise from the complex web of derivatives deals that are created between regular market participants. As discussed earlier, participants in the market will enter into a transaction with one party and then seek to hedge the risk created with another party. Each market participant is therefore hedging risks with one another. Every transaction creates a hedging transaction which will in turn create more hedging transactions, and so on. Systemic risk constitutes the risk that, if one player in the market goes into insolvency and is unable to meet its payment obligation, this will introduce stress into the remainder of the market creating a risk that more players will be forced into a position where they are unable to meet their payment obligations because they have not been paid by the insolvent party. It is this 'domino effect' which is the essence of systemic risk.

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credit support documentation will not be sustainable in the light of the decisions in *Islington* and *Kleinwort Benson v. Glasgow C.C.*.

[52] [1994] 4 All E.R. 890, 960.

[53] [1994] 4 All E.R. 890, 961.

[54] The joined appeal with *Islington* at first instance: [1994] 4 All E.R. 890.

[55] On this issue see *Amicus Curiae* , November 1997, Vol. 2, p.27.

The market place has sought to introduce some protection against this form of total market risk by standardising market practices and standardising legal documentation. The work of ISDA and of the BBA, among others, has been to ensure that termination provisions, payment systems and netting provisions are both standardised and legally effective. This is the source of the derivatives market's particular concern about the decisions affecting local authorities. At one level, the finding in *Hazell* that local authorities were not capable to enter into interest rate swaps caused concern with reference to deals with local authorities. However, the greater disquiet has been caused by the manner in which English law has both failed to enforce the terms of those standard market contracts and the denial of proprietary remedies to market participants.

The core concern which is posed by systems of insolvency law is the ability of a solvent party to a transaction to enforce the contract against an insolvent party. The risks are similar where one party is unable to perform under the agreement for reasons other than insolvency. While there is not the same risk of an inability to recover any money from the defaulting party, there is the risk that an open position is created by the hedge to the defaulted transaction, that the economic purpose for which the contract was created will be frustrated and that inability to receive payment will add to systemic risk. Where market participants are unable to perform, the risk posed by financial derivatives is a haemorrhaging of liquidity. The notion of liquidity is different from solvency, but the economic risks are similar. The aim of a treasury function within a trading company or bank is to provide liquidity without impacting on the solvency of the entity in one way or another. Liquidity means matching obligations with ability to pay. Derivatives markets aim to add to this pool of liquidity as well as to add speculative opportunities. Where payment in full under derivatives contracts is precluded by operation of law, there is an increased level of liquidity risk in the market place.

The market place has sought to introduce some protection against this form of total market risk by standardising market practices and standardising legal documentation. The work of ISDA and of the BBA, among others, has been to ensure that termination provisions, payment systems and netting provisions are both standardised and legally effective.[56] This is the source of the derivatives market's particular concern about the decisions affecting local authorities. At one level, the finding in *Hazell* that local authorities were not capable to enter into interest rate swaps caused concern with reference to deals with local authorities. However, the greater disquiet has been caused by the manner in which English law has both failed to enforce the terms of those standard market contracts and the denial of proprietary remedies to market participants.

Allocation of risks in derivatives documentation

Much has been said in the introductory argument about the determination of the English courts in the swaps cases to refuse to consider the terms of the contracts entered into between the parties.[57] The core argument asserts that arguments based on risk allocation and suitability of product should not be dismissed because they are

[56] The details of these forms of contract are analysed in Hudson, *The Law of Financial Derivatives* (Sweet & Maxwell, 1996).
[57] This discussion is amplified below in *Problems of Credit and Security*.

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based on void contracts. As submitted above, the calculation of risk and the structuring of financial products to meet those risks are the foundations of the creation of financial derivatives. Furthermore, the attitude of the courts would appear to make it impossible to effect credit support for such transactions in circumstances where they are held to be founded on unenforceable contracts. It is contended below that it would be possible to adapt either equitable or restitutionary principles to give effect to the common intention of the parties.

The markets attempt to allocate risks generally by means of standard form documentation. In all cases, such documents are predicated on the basis that the parties can enter into the transactions which they purport to effect. The BBAIRS agreement (British Bankers Association Interest Rate Swap standard terms)[58] provides as follows:-

> 1. "Representations and Warranties
>
> 1.1 Each party represents and warrants to other that:-
>
> i) it has full power and authority (corporate and otherwise) to enter into this Agreement and to exercise its rights and perform its obligations hereunder and has obtained all authorisations and consents necessary for it so to enter, exercise rights and perform obligations and such authorisations and consents are in full force and effect;
> ii) the obligations expressed to be assumed by it under this Agreement are legal and valid obligations binding on it in accordance with their terms …
>
> 5. Events of Default
>
> The occurrence of any one or more of the following circumstances in respect of either party … shall be an Event of Default:
>
> i) failure by the Defaulting Party to pay any sum due and payable hereunder within three Business Days of receipt of written notice from the other party … that such sum is overdue; or
>
> iv) any representation made or warranty given by the Defaulting Party pursuant to Clause 1 is or proves to have been materially incorrect or misleading when made."

Therefore, the failure of a representation of ability to contract or to perform any payment obligation is a breach of the express terms of the contract which is capable of compensation in the contractually provided manner by the party which is unable to perform under the contract. It is not true to say, therefore, that there was no attempt to allocate risks under the express terms of these agreements. What is not clear from the

[58] Published by the BBA.

facts of the judgements is whether or not there was any added credit enhancement provision available.

It should noted that the BBAIRS terms were intended to be a default market standard agreement for market participants operating on the London interbank market.[59]

The ISDA (International Swaps and Derivatives Association) 1992 edition of the Multicurrency Master Agreement[60], provides:-

1. Interpretation

c) Single Agreement. All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as 'this Agreement'), and the parties would not otherwise enter into any Transactions,

3. Representations

(a) Basic Representations

(i) Status. It is duly organised and validly existing under the laws of the jurisdiction of its organisation or incorporation and, if relevant under such laws, in good standing;
(ii) Powers. It has the power to execute this Agreement and any other documentation relating to this Agreement[61] to which it is a party, to deliver this Agreement and any other documentation relating to this Agreement that it is required by this Agreement to deliver and to perform its obligations under this Agreement and any obligations it has under any Credit Support Document to which it is a party and has taken all necessary action to authorise such execution, delivery and performance;
(iii) No Violation or Conflict. Such execution, delivery and performance do not violate or conflict with any law applicable to it, any provision of its constitutional documents, any order or judgement of any court or other agency of government applicable to it or any of its assets or any contractual restriction binding on or affecting it or any of its assets;
(iv) Consents. All governmental and other consents that are required to have been obtained by it with respect to this Agreement or any Credit Support Document to which it is a party have been obtained and are in full force and effect and all conditions of any such consents have been complied with; and

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[59] "5. … With effect from 2nd September 1985 … in the absence of clarification to the contrary, banks and brokers in the London interbank market will be assumed to be operating on BBAIRS terms for swaps of less than 2 years maturity within the defined categories."
[60] Published by ISDA.
[61] This would include the Credit Support documentation set out later in the Agreement and required to be specified precisely in the Schedule to the Agreement.

(v) Obligations binding. Its obligations under this Agreement and any Credit Support Document to which it is a party constitute its legal, valid and binding obligations, enforceable in accordance with their respective terms …

5. Events of Default and Termination Events

(a) Events of Default. The occurrence at any time with respect to a party or any Credit Support Provider of such party or any Specified Entity of such party of any of the following events constitutes an … Event of Default with respect to such party:-

(iv) Misrepresentation. A representation made or repeated or deemed to have been made or repeated by the party or any Credit Support Provider of such party in this Agreement or any Credit Support Document proves to have been incorrect or misleading in any material respect when made or repeated or deemed to have been made or repeated …"

In the event of such early termination, the non-defaulting party (on giving the necessary notice and allowing for any applicable grace period) is entitled to nominate a date on which the Agreement is to terminate. On that date, a single termination amount is to be calculated. That amount is a net amount representing the net position between the parties calculated either as the replacement cost of the terminated transactions[62] or with by reference to the loss suffered by the non-defaulting party. 'Loss' in this context expressly includes a good faith estimate of 'losses and costs … including any loss of bargain, cost of funding … loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position'.[63] Also captured within the definition of 'loss' are any costs associated with delivery of goods under physically-settled transactions.

Thus the ISDA Master Agreement expressly deals with a broad range of events of default (including those relating to misrepresentations) and provides for a sophisticated mechanism terminating transactions and calculating appropriate levels of reparation and compensation. Clearly, there is an express mechanism for both calculating and allocating risks on the happening of a number of specified events. It is submitted that to overlook the impact of those standard market documents is to deny the risk allocation that is provided by the marketplace and by the individual, contracting parties.

Where an over-the-counter market is under pressure from regulators and legislators as to the future treatment of the market,[64] and increased concerns about the safety of the markets and of investors in the wake of the Barings and the Orange County affairs, the

[62] Such values are calculated by reference to quotations from nominated market makers in those transactions.
[63] ISDA Multicurrency Master Agreement, 1992 edn., section 14.
[64] See for example, the 1994 Derivatives Supervision Bill presented to US House of Representatives on 26th January 1994; as reproduced in '*The Law on Financial Derivatives*', Alastair Hudson (Sweet & Maxwell, 1996), 318-331.

denial of efficacy to market-based initiatives for the standardisation and risk management of derivatives products by the English courts is an unfortunate development.

The nature of the property in question: 'money'

In financial market transactions money divides between physical foreign exchange and "cash value equivalent". The notion of 'value' is perhaps closer to money in this context. It is unusual for there to be real physical settlement of cash in financial transactions. The use of electronic funds transfer is the re-allocation of debts - that is, value held in electronic bank accounts is assigned to other accounts. There is no physical settlement in the sense that is understood by the transfer of tangible chattels. Even the delivery of physically-settled transactions in the foreign currency markets takes place at a virtual level. While there is generally an entitlement to claim delivery of notes and coins in respect of the value held in a bank account, it is rare for such delivery to take place.

Global financial markets operate at the level of the transfer of "equivalent value" and base many of their decision on an arbitrage between different value measurement mechanisms. An amount of sterling held in a bank account will have its market value altered from day-to-day, minute-to-minute as the value of sterling fluctuates in the marketplace. Sterling's market value will change according both to its value compared to competitor currencies and in relation to the interest rate which attaches to deposits of sterling in the money markets.

Mann sought to achieve a legal definition of 'money':-

> '… the quality of money is to be attributed to all chattels which, issued by the authority of the law and denominated with reference to a unit of account, are meant to serve as universal means of exchange in the State of issue.'[65]

Mann dealt with chattels as attracting the quality of money. Either this definition is to be said to be defective because it does not include electronically-held units of value, or, alternatively, electronically-held units of value should be considered to be something other than 'money' in legal terms.

Goode describes money as fungible in that any unit of account is capable of being exchanged for any other unit of account.[66] However, the issue remains that it does have to be segregated for trust or for tracing purposes before any proprietary claim can be established.[67] Thus, where a bank account goes overdrawn, the money that was held in that bank account is said to disappear.[68] This runs counter to Goode's assertion that the nature of money is such that it ought not to matter which part of the fund is allocated, subject to the proprietary base required to found an equitable tracing claim.

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[65] F.A. Mann '*The Legal Aspect of Money*', 5th edn. (Oxford, 1992), 8.
[66] Goode, Commercial Law 2nd edn. (Penguin,), 491.
[67] *Re Goldcorp* [1995] 1 AC 74; *Boscawen v. Bajwa* [1996] 1 WLR 328.
[68] *Boscawen v. Bajwa* [1996] 1 WLR 328; *Roscoe v. Winder* [1915] 1 Ch. 62.

In this context, the Court of Appeal has accepted that where a fund of identical units is impressed with a trust equal to 5% of their total value, there is no requirement to segregate out a fund equal to that 5%.[69] This decision, is however, in opposition to the speech of Lord Browne-Wilkinson in *Islington*[70] and the speech of Lord Mustill in *Re Goldcorp*[71] which provide that for a fund to be impressed with a trust, it must be certain which property makes up that fund.

The difficulty caused by these analyses of money, as Millett J. held in *Agip v. Jackson*,[72] is the impossibility of maintaining an action for tracing at common law where money was moved between accounts by means of 'telegraphic transfer'.[73] The property which was being dealt with in *Agip* was really a transmission of electrons between computers which evidenced debts of money in the form of bank accounts. Similarly, the issues before the House of Lords in *Westdeutsche Landesbank v. Islington* were concerned with the payment, and sought-after repayment, of amounts of money represented by electronic bank accounts and telegraphic transfers. Indeed Lord Goff makes the following point early in his judgement:-

> '… the basic question is whether the law can restore the parties to the position there were in before they entered into the transaction. I feel bound to say that, in the present case, *there ought to be no difficulty about that at all, This is because the case is concerned solely with money. All that has to be done is to order that each party should pay back the money that it has received* - or more sensibly strike a balance, and order that the party who has received most should repay the balance; and then to make an appropriate order for interest in respect of that balance. It should be as simple as that. And yet we find ourselves faced with a mass of difficult problems, and struggling to reconcile a number of difficult cases.'[74] [author's emphasis]

It is as though the practical problem is so straightforward ('pay back the money') and yet a number of issues of legal analysis arise concerning the proprietary and personal nature of the remedies, and the applicable codes of rules under which they should be awarded. Nothing but a stream of electrons passes between the banks as a result of telegraphic transfers.[75] So, the very nature of inter-bank clearing systems creates problems of identifying property.[76] The broader issues of property law involved in money laundering and tracing property in money is created by the very intangibility of the property involved.[77]

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[69] *Hunter v. Moss* [1994] 1 WLR 452.
[70] [1996] AC 669.
[71] [1995] 1 AC 74.
[72] [1990] Ch 265; affirmed at [1992] 4 All E.R. 385.
[73] [1990] Ch 265, 279.
[74] [1996] 2 All E.R. 961, 966.
[75] *Agip v. Jackson* [1990] Ch 265, 286, *per* Millett J.; CA [1991] Ch 547.
[76] (1995) 54 CLJ 377 (A. Oakley).
[77] Birks (1989) 105 LQR 258; Millett (1991) 107 LQR 71; 50 CLJ 409 (C. Harpum); [1992] Conv. 367 (S. Goulding); All ER Rev. 259 (Swadling).

3. *Availability of proprietary remedies*

The issue also arises: what constitutes a proprietary claim with respect to this type of intangible, virtual property? Having the use of value in an electronic account was accepted in *Islington* as connoting an ability to earn compound interest on it.[78] In the context of financial contracts, compound interest is the appropriate measure of proprietary title. Therefore, the approaches of Lord Goff and Lord Woolf in *Islington* to award compound interest while expressly disavowing proprietary claims for the bank appear to be counter-intuitive where that award would have been tantamount to a proprietary remedy in any event.

The restatement of the core rules of equity in the leading speech of Lord Browne-Wilkinson in *Westdeutsche Landesbank v. Islington* created a test that a proprietary claim in constructive trust 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, thus affecting his conscience. Similarly, a proprietary claim based on resulting trust will only obtain where a purported express trust of an equitable interest has failed to allocate the whole of that interest, or where an equitable interest is created by dint of contribution to the purchase price of property. 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 House of Lords was unanimous in holding that neither the lump sum nor any of the interest amounts were to be held on resulting trust. Further, it was unanimous in holding that there would not be constructive trust imposed over the money on the basis that the local authorities did not know that the money had been advanced to them under a void transaction and therefore their consciences had not been affected. At most there was a personal claim in restitution for the amount of money transferred under the void agreement together with simple interest.[79]

The impact of the decision is that, even though it was accepted that the parties would have expected to receive compound interest on their money in ordinary circumstances and that they had entered into the standard form contracts, parties to financial contracts will not be entitled to proprietary remedies where those agreements are held to be void. Furthermore, it appears from the decisions that any contractual provision which sought to preserve such proprietary rights would itself be void, making the retention of title in such agreements impossible.

Prof Birks refers to their being no real difference between Lords Goff and Browne-Wilkinson in the interpretation of the equitable and restitutionary techniques available in

[78] It is submitted that to arrive at any other measure of the proprietary rights attached to money would be too speculative in any event.

[79] Lord Goff and Lord Woolf dissented on the availability of compound interest: the former asserting that it ought to have been available on the grounds of justice, the latter asserting that commercial people would expect that it would be made available.

Westdeutsche Landesbank.[80] Birks is somewhat dismissive of the extent of any change that is introduced by Lord Browne-Wilkinson.[81]

The availability of equitable proprietary remedies

Lord Browne-Wilkinson held that there could be no retention of any rights in the deep discount payment by the bank because both parties intended that there be an outright transfer of that sum to the authority. The argument for the imposition of a resulting trust would be that there was no intention to make a voluntary and outright transfer of the property in circumstances where the contract is found to be void ab initio.[82] The radical restitutionary approach, typified by the work of Prof. Birks in seeking to understand the core rationale for effecting restitution to be a remedy for unjust enrichment by subtraction of that enrichment, is considered expressly by their lordships. For the most part the radical approach fairs badly before the House of Lords. Prof. Birks suggests that the role of the resulting trust is primarily restitutionary and that this form of resulting trust should be imposed in cases of mistaken payment or failure of consideration to reverse unjust enrichment.[83] At the root of both arguments in favour of the use of the resulting trust is the assertion that the most appropriate response is to hold that the equitable interest in the property in question is to be deemed to have remained with the payer - whether that assertion is based on equitable or restitutionary conceptions of justice.

However, it is submitted that these suggestions fall into the trap which Lord Browne-Wilkinson has identified: any intention to create a resulting trust is to be rebutted by the intention at the time of the transfer to make an outright transfer. As his lordship held, there is a difficulty with establishing the role of the resulting trustee from the moment of receipt of the property at a time when there was no knowledge of the trusteeship.

The better approach, not addressed expressly by any of the courts in *Islington*, would be to extend the common intention constructive trust to commercial situations. Whereas this idea has been restricted to family home trusts, among the competing claims to resulting trusts, unjust enrichment and proprietary estoppel in that context, it is an idea which would appear to sit most comfortably in commercial situations. The weakness of the common intention constructive trust, as with all rules governing trusts of co-owned domestic land, is that it rests on a fiction. The fiction is that there has been some agreement between the parties, or some conduct tantamount to an agreement, which ought to form an institutional constructive trust (that is, one founded on the application of principle rather than being a discretionary remedy provided by the court). As a result of this fiction, a constructive trust is imposed to set out the parties' entitlements to the equitable interest in the land. This form of trust is imposed particularly where it is considered inequitable not to do so.

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80 [1996] RLR 3.
81 [1996] RLR 3.
82 In this regard, see Worthington '*Proprietary Interests in Commercial Transactions*' (Oxford, 1996), xi.
83 See Birks, 'Restitution and Resulting trusts ' in S. Goldstein, (ed.), *Equity and Contemporary Legal Problems* (1992), 335.

In the context of commercial contracts there *is* an agreement between the parties. In seeking to establish the equitable title to property passed under a void contract, it is submitted that the court ought to consider the common intention formed between the parties as to the title to that property. Given Lord Browne-Wilkinson's determination to recognise the intentions of the parties in refuting the possibility of a resulting trust, it would appear appropriate to recognise those intentions when considering the possibility of a constructive trust. This would also appear to address the concerns of Lord Goff and Lord Woolf that justice must be seen to be done and that the confidence of commercial people in the utility of English law must be promoted.

Lord Browne-Wilkinson rejected the possibility of a proprietary interest based on constructive trust on the basis that the English model of constructive trust is institutional in nature, operating in response to the trustee's knowledge of some factor which ought to impact on his conscience sufficiently to warrant the imposition of such a constructive trust. On the facts of *Islington* it was found that the authority did not have knowledge of the status of the contract until it was declared to be ultra vires by the courts.

However, at that point there is another impact on the authority's conscience: it had already agreed with the bank that it would be bound by the termination provisions in its swap agreement (including calculation of interest and netting of transactions). It is submitted that this prior agreement ought to be sufficient to cause the authority to be bound by those terms of the swap contract with regard to the amount owed under the agreement. Similarly, such common intention as to termination and proprietary rights in assets transferred by arm's length market participants should be enforced by equity through the common intention constructive trust.

In the event, the weakness of the market standard contracts for over-the-counter derivatives is that they do not cater sufficiently for retention of title in property. There is clearly an issue for ISDA and for the BBA to re-draw its standard contracts to take account of this deficiency in counterparty protection. This is particularly so in the case of physically-settled transactions and transactions annexed to deep discount payments where title to the specific property transferred is of greater importance than receipt of its cash equivalent in a designated currency.

The issue which arises is: how can a void contract be given effect to in part? More specifically, if the swap contract is held to have been void ab initio, how can the termination provisions or retention of title clauses be effective still. There are two arguments on this basis. First, it is clear from *Re Goldcorp*[84] that if a contract is avoided by election of the parties, and property transferred under that contract can still be identified, a constructive trust will be imposed over that identifiable property. Therefore, there is a difference between the enforceability of a voidable contract and a void contract as a result of *Islington.*[85]

Second, it is submitted that it would be possible to sever the termination provisions from the economic provisions of the swap contract, as considered above. The risk

[84] [1995] AC 74; also Worthington , *supra*..
[85] It is accepted that in *Islington* the property was no longer identifiable because the bank account into which the property had been paid had subsequently been run overdrawn on a number of occasions.

management features of standard market financial documents introduce greater certainty and lessen the cash amounts required to be paid between market participants. Therefore, the identified policy of precluding the parties from entering into further damaging transactions does not apply in the context of a provision, such as a netting clause on termination, which reduces the net amount of the parties' exposure to one another. The validity of an instrument need not be compromised because some element of it is held to unenforceable.[86]

Conclusion

In considering commercial situations, the appropriate rules of equity should be a remedy by means of an equitable proprietary remedy should be made available to a party where the contractual agreement between the parties allocates title to the property transferred under the transaction, or the award of a proprietary remedy would accord with the common intention of the parties set out in agreement between the parties. It is similarly arguable that such a remedy ought to be available where there was some undue influence in the creation of the financial product, or either party was caused to be unjustly enriched at the expense of the other party, or where rescission is the appropriate remedy under a physically-settled transaction.

It is suggested that the usual defences of change of position and passing on would still obtain. Similarly, public policy would constitute an exception in such circumstances. A remedy by means of equitable compensation or by imposition of personal liability under constructive trust should be made available in cases of reckless risk-taking; or where the product was unsuitable; or if rescission is the appropriate remedy under a cash-settled transaction[87]; or if the risk taken, or the context in which the risk was taken, contravened some principle of public policy or of statute or of some other mandatory rule of law or equity.

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, produces inequitable results between those parties, circumscribes the efficacy of English law in the context of financial agreements, and introduces further risk to financial markets by rendering otiose the terms of those standard form agreements.

The 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. Among these terms are provisions for the termination of contracts in a manner which reduces systemic risk while also reducing the immediate financial pressure on the parties to a contract on the happening of a termination event. The English courts have chosen to consider these contracts to be unenforceable. As a result, the markets' attempts to introduce effective, consensual, ad hoc regulation of the derivatives markets have been rendered ineffective.

[86] *Gaskell v. King* (1809) 11 East. 165; *Gibbons v. Harper* (1831) 2 B. & Ad. 734.
[87] Absent any remedy identified as a proprietary remedy above.

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What is not supportable is the dismay in the commercial community outside the UK which relies on English law. Lord Woolf referred to the need for a 'modern test' in financial transactions based on foreseeability of loss.[88] As Lord Browne-Wilkinson found in *Target Holdings*[89] there is a need to break from the application of traditional rules to commercial situations and consider the commercial context for equity. Lord Nicholls has accepted the need to recognise inappropriate risk-taking by a fiduciary as a ground for a claim in equity.[90] In the context of financial contracts, equity must accept the need to account for risk and suitability of product. As a corollary to this, it must enforce the common intention of the parties as to the termination of financial contracts.

[88] *Islington* [1996] A.C. 669, [1996] 2 All E.R. 961, 1016; citing, with approval, Dr F.A. Mann 'On Interest, Compound Interest and Damages' (1985) 101 LQR 30.
[89] [1996] 1 AC 421.
[90] *Royal Brunei Airlines v. Tan* [1995] 2 A.C. 378.

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