Dealing with Derivatives

Prof Alastair Hudson

DEALING WITH DERIVATIVES

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BIOGRAPHY

Alastair Hudson is a Barrister and Professor of Equity & Law at Queen Mary, University of London.

He is the author of a number of books in the area of international finance: *The Law on Financial Derivatives*, 3rd edition (London: Sweet & Maxwell, 2002, 653pp: 4th edition to be published in the summer of 2004), *Swaps, Restitution and Trusts* (London: Sweet & Maxwell, 1999, 245pp), *The Law on Investment Entities* (London: Sweet & Maxwell, 2000, 356pp); and editor of two collections of essays *Credit Derivatives* (London: Sweet & Maxwell, 1999) and *Modern Financial Techniques, Derivatives and Law* (London: Kluwer, 2000).

In relation to chancery law he is the co-author of *The Law of Trusts* (Oxford University Press, 2004, 1,907pp); and the author of *Equity & Trusts* (London: Cavendish, 4th edn, 2005, 1,092pp) and *Understanding Equity & Trusts* (London: Cavendish, 2nd edn., 2004, 219pp). Among his other book-length publications are contributions to *Palmer's Company Law* on "Capital Issues: Part 5" and "Open-ended Investment Companies: Part 5A". He has also edited *New Perspectives on Property Law, Obligations and Restitution* (London: Cavendish, 2004, 378pp) and *New Perspectives on Property Law, Human Rights and the Home* (London: Cavendish, 2004, 334pp).

He lectures undergraduate and postgraduate courses in equity and trusts, land law, and numerous aspects of banking law at Queen Mary, University of London. Before that, Alastair worked for Goldman Sachs and Citibank NA in the area of financial derivatives and global finance.

He has also published books in the area of law, social exclusion and the welfare state: *The Law on Homelessness* (London: Sweet & Maxwell, 1997, 449pp) and *Towards a Just Society: law, Labour and legal aid* (London: Pinter, 1999, 286pp). In the 1997 General Election he stood for Labour in Beaconsfield managing to force the resignation of Tim "cash-for-questions" Smith MP, to win an effective 29% swing to Labour, but nevertheless to lose in a landslide. He was previously advisor to the Labour Party front-bench on legal and other issues between 1992 and 1997.

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Session One

(1) Commercial and structural aspects of financial derivatives

1.1 What is a derivative and what is its purpose?

1.2 Law as risk management

1.3 The structure of derivatives: from options and forwards to interest rate swaps

1.4 Complex derivatives: equity swaps and credit derivatives

1.5 Repackaging derivatives using alternative legal analyses

1.1 WHAT IS A DERIVATIVE AND WHAT IS ITS PURPOSE?

It is difficult to know with any precision when the first derivative contract was created. It is clear, however, that derivatives in various forms have been in existence for some considerable time. The ancient Greeks used to trade olive oil futures, that is contracts fixing the price of olive oil at some time in the future, and in Holland the sale price of tulips was fixed in similar fashion as long ago as the seventeenth century. Both of these futures contracts fixed a price in the future at which the right-holder agreed to buy a given quantity of either olive oil or tulips. There are tales of even more ancient Babylonian kings selling instruments which permitted the holder of the instrument to call on the king to deliver up one mercenary soldier and two slaves for each instrument held on payment of the price specified in the instrument. This particular contract for the acquisition of soldier is similar to something which will be described below as being a physically-settled call option in that it permits the buyer of the option to call for delivery of an identified form of asset in consideration for the payment of the contractually specified price.

Significantly, all of these contracts in themselves, whether the Greek olive oil future, or the Dutch tulip future, or the Babylonian mercenary instrument, are capable of being traded. That is, each of these contracts is capable of being sold, pledged or otherwise transferred to third parties. The essence of these contracts as derivatives contracts is that they are transferable and thus bear their own independent value which is in turn derived in some way from the asset – whether olive oil, tulips or mercenaries – which underpins the contract.

What is important to divine from these fragments of historical trivia is that the ideas which underpin the modern financial derivatives markets are well-established. They are all based on the essential characteristics, from a lawyer's perspective, that a right-holder be entitled to receive some payment or asset on the exercise of its rights under a contract which itself has a distinct value. It is possible at general law for contracts to have their own values and for contracts to be transferable: the purpose of this book is to uncover, analyse and explain those financial instruments which are classified as being financial derivatives from within that more general class of transferable contracts and obligations.

WHAT IS A "DERIVATIVE"?

The term "derivative" does not have a precise definition. The closest we can come to a definition is probably the following:-

> 'A derivative product is a financial product that derives its value from another, underlying financial product.'

For example, an option to buy a share is a financial product which derives its value from that underlying share. Similarly, an interest rate swap derives its value from the value of the cash flows on the underlying loan. Hence the term "derivative".

From a legal point of view, we can identify the derivative and the underlying financial product as being linked in the minds of the market participants when the derivative is created. However, the parties' lawyers do not necessarily consider the role of the underlying in the documentation - often, the only mention of is with reference to market disruption event provisions (discussed below).

The underlying products are all very different. Their prices have little connection: commodities markets usually behave in a way that is distinct from equities markets and so on. However, the techniques used by the derivatives trader or risk manager are the same whether that person is looking to speculate on market movements or to hedge their exposure to a risk.

The heart of the derivative product is the cash flow. As all business school degrees will tell you: 'cash flow is king'. The speculator uses cash flow to generate income. The risk manager seeks to offset one cash flow (for example an exposure to interest rates) with a different cash flow that operates in an inverse manner (for example by purchasing securities).

One of the greatest attractions of a derivative in the market place is its malleability. Therefore, the task facing the lawyer is how to cope with financial products which are volatile, complex and, by their very nature, extremely fluid. The real issue for the regulator is therefore one of controlling risks in a volatile and expanding marketplace.

The real reasons for the financial derivatives becoming and remaining established as part of the financial landscape are:

- the flexible opportunities they offer to financial institutions, investors and companies seeking protection from financial market risk;
- the opportunity for high returns on low entry prices for investors; and
- the creative opportunities to meet market movements.

COMMERCIAL USES OF DERIVATIVES

The fundamental question is to explain why a derivative product is necessary in any event. The goal of all derivative products is to obtaining funding at a preferential rate or to take speculative advantage of a movement in a financial market for the investor.

The use of derivatives products has expanded rapidly in the late 1980's and 1990's because of the increased volatility in world financial markets. During this period of flux, the complex structures have proved themselves able to take advantage of profit-making opportunities and to offer protection against the risk of loss in the underlying financial markets.

Therefore there are two fundamental reasons why derivatives are used:

- Earning income
- Managing risk

To achieve these core goals there are four basic forms of activity:-

1. Speculation
2. Hedging
3. Asset liability management
4. Arbitrage

1. Speculation

A derivative product may enable an investor to mimic the result of trading on an underlying financial market by entering into an off-market transaction with a financial institution. Therefore, a company can obtain the effect of speculating on the FTSE-100 without actually having to buy shares in companies in the FTSE-100.

2. Hedging

Derivative products can also be used as a risk management tool against market movements or rate changes. Purchase of a derivative product will enable the buyer to control its exposure to standard financial operations as disparate as its ordinary borrowing or its exposure to other investments.

3. Asset Liability Management

The growth in mixed portfolio funds has benefited from the capacity of derivatives to construct mixed hedging and speculation strategies. Where a financial, or other, institution seeks to deal with its portfolio of liabilities, their size and exposure to market movements can be massaged by the use of derivative instruments. Where a portfolio is weighted to heavily towards an exposure to sterling, derivatives can change that exposure to another currency entirely.

4. Arbitrage

The use of derivative products makes it possible for market users to take advantage of mismatches in prices or market conditions by speculating on the underlying financial products without the need to undergo the formalities of conventional market trading. An American option to trade on a market, enables the investor to take advantage of price differentials which occur during the life of the option. Derivatives markets in themselves contain the possibility to generate arbitrage opportunities and can be used as part of an arbitrage strategy as a result.

5. Other possible uses

Derivatives can also be used for objectives which are not specifically geared to speculative profit or hedging. There are often regulatory or capital adequacy goals in investing in one particular type of derivative instrument rather than owning market instruments or obligations. Similarly, there are often accounting advantages in holding derivative instruments rather than ordinary financial instruments. Under most accounting codes, interest rate swaps or options to enter into currency swaps are not required to be disclosed separately on a company's balance sheet, whereas an underlying loan would be required to be disclosed.

1.2 Law as risk management

The main risk faced by the lawyer with reference to all derivatives is that the other party to the transaction will fail to pay. Thus, the enforceability of financial derivatives in the event of the insolvency of one or other party, has become almost the standard for defining the nature of a financial derivative product.

The following are the main risks involved:-

Systemic risk;
Market risk;
Counterparty risk;
Payment risk;
Documentation risk;
Operations, technology and audit risk;
Personnel risk;
Performance measurement and accounting risk;
Basis risk;
Political risk;
Management risk;
Concentration risk;
Limit risk;
Rollover risk;
Hedging risk;
Credit risk;
Interest rate risk;
Pre-payment risk;
Re-investment risk;
Volatility risk;
Netting risk;
Currency risk;
Commodity risk;
Equity risk;
Call risk;
Yield curve risk;
Curve construction risk;
Raw data risk;
Regulatory risk;
Tax risk;
Capital risk;
Liquidity risk;
Insolvency risk;
Collateral risk;
Modelling risk;
Cross-market risk;
Cross-default risk

1.3 The structure of derivatives: from options and forwards to interest rate swaps

The underlying assumption of these materials is that all derivatives can be reduced to a few basic forms and structures. There are three basic forms of product:

- the swap,
- the forward and
- the option.

All other derivatives are built on these building blocks.

In the modern marketplace, the bank is a warehouse for debt obligations and takes the place of the reciprocally configured market counterparty. Therefore, parties will transact with banks and the banks will undertake, where the terms of the transaction are considered to be viable, to meet the obligations of the counterparty.

Forms of settlement

It is important to state that most modern forms of over-the-counter derivatives are cash settled. Therefore, while they are transacted and documented according to a notional amount of currency or a notional number of specified securities, the value transferred between the parties is a cash amount calculated by reference to the notional amounts of underlying assets.

There are some products which do use physical settlement. Aside from the futures markets (on-exchange, as opposed to over-the-counter derivatives), there are a number of products which are used by buyers to ensure access to physical assets. This is most common in commodities and securities derivatives.

There is a third category of derivative product which is capable of being settled 'either way'. This gives the buyer the option to receive physical securities or to settle for the cash amount.

As considered below, the form of settlement may have an impact on the restitutionary possibilities available to the parties. The descriptions of derivative products below aim to give an indication of the form of the most common types of derivative. The beauty of the derivative, its malleability, also makes it difficult to conceptualise at times.

Swaps

A swap is an exchange of cash flows. More specifically a swap is an exchange of the rate of interest that a borrower is currently paying for a different rate of interest which it wishes to pay. Company A will agree to pay the interest on the debt it owes to B bank, in return for which Company A will pay a different rate of interest to the Bank C with which it has entered into the swap. This is a simple exchange of cash flows for a fee.

The most common form of swap is the interest rate swap. An interest rate swap is an agreement between parties to make periodic payments to another party in the same currency. The commercial aim of the transaction is to obtain funding at a preferential rate of interest or to alter the cost of funding of an existing debt.

Often A and B can obtain different costs of funding: if they can exchange their available terms to their mutual advantage, this is a useful way for them to do business. For example, a German bank will be able to obtain deutschemarks more cheaply than a UK company. Therefore, it is better that the German bank borrow the money and then enter into a swap with the UK company to give that UK company the benefit of the lower rate of interest (including its own profit margin).

Swaps are also used to achieve the return on an equity market. For example, if A wants to receive the likely return on the FTSE-100 index without the need to buy one hundred sets of shares, an equity swap can be created. By reference to a notional amount of capital, A can pay B an agreed fixed amount, in return for which B pays A the return that notional amount of money would have generated on the FTSE-100.

A's profit margin (or hedge) is therefore the difference between the fixed amount paid to B and the floating amount received. Both parties take the risk on the performance of the FTSE-100. B makes a profit either from the risk of the FTSE-100's performance and from including a spread in the level of the fixed amount paid by A.

It may also be that the currency in which the payments are made can be obtained by B at a preferential rate. Alternatively, B might simply want A's other banking business and therefore would enter into this transaction as part of a range of client services. These are two generic reasons why banks enter into this derivatives business with corporate clients.

This treatment of company securities is becoming more and more common as a means of cheap speculation and also as a means of risk management using equity indices.

An interest rate swap was described by Woolf LJ in *Hazell* in the following terms:-[1]

> "[An interest rate swap is] an agreement between two parties by which each agrees to pay the other on a specified date or dates an amount calculated by reference to the interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case. For example, one rate may be fixed at 10% and the other rate may be equivalent to the six-month London Inter-Bank Offered Rate (LIBOR). If the LIBOR rate over the period of the swap is higher than the 10% then the party agreeing to receive "interest" in accordance with LIBOR will receive more than the party entitled to receive the 10%. Normally neither party will in fact pay the sums which it has agreed to pay over the period of the swap but instead will make a settlement on a "net payment basis" under which the party owing the greater amount on any day simply pays the difference between the two amounts due to the other."

This definition was cited with approval by Lord Templeman in the House of Lords in *Hazell v. Hammersmith & Fulham L.B.C.*.[2]

[1] [1990] 2 Q.B. 697, 739; [1990] 3 All E.R. 33, 63.
[2] *Hazell v. Hammersmith & Fulham LBC* [1991] 1 All E.R. 545, 550.

Commercial uses of swaps

A company may wish to fix the rate of interest that it is paying so that it can forecast its future cash flows with confidence. This may be as part of a corporate restructuring or the re-negotiation of its borrowing limits with its banks. In the past it may only have been able to obtain floating rate funding. The bank will therefore pay the corporate's floating interest rate obligations in return for which it will receive an agreed upon fixed rate of income from the corporate.

Example

The amount of cash to be paid as this interest rate is calculated by reference to a notional amount of money. For example, where A Ltd has a loan from Y Bank of GB£10mm at floating rate of LIBOR+100 basis points, it may seek to pay a fixed rate of interest at 9%. The reason for this may be to fix its future cash outflows for strategic planning purposes but it is most probably based upon an expectation that LIBOR will rise, such that LIBOR +100bp will be more than 9%.

A Ltd 9% -> X Bank

LIBOR + 100bp

|
V

Y Bank

Therefore, X Bank will pay A Ltd's obligation of LIBOR +100bp to Y bank. In consideration for X Bank discharging A Ltd's obligation to Y Bank, A Ltd pays a fixed rate of 9% to X Bank.

A Ltd's gain is the fixing of its interest payments and a profit where LIBOR +100bp exceeds 9%. X Bank makes a profit on any fee it charges for the transaction (which is usually built into the fixed rate of interest which it receives) and also makes a profit where LIBOR +100bp on GB£10mm is less than an interest rate of 9% on GB£10mm.

Currency Swap

Example

Where A Ltd seeks to acquire French francs but is unable to acquire them at a level below FFR/GBP 100, A Ltd may enter into a swap whereby, the fixed amount of sterling is swapped for a floating amount of French francs at a rate which it expects will remain below FFR/GBP 100. The transaction is entered into on the basis that the French franc equivalent of GBP 1.0mm will be delivered to it on the physical settlement date in the confirmation.

It might be that A Ltd approaches X Bank to borrow French francs and is told by French Bank that A Ltd's credit rating in the French banking market will not enable X Bank to lend to it at less than a fixed rate of 8%. However, French Bank may be able to offer a package in which A Ltd is lent the money in sterling at 7.5% because of its better credit approval among UK banking institutions. A would then be allowed to swap that interest rate in sterling for a given floating rate of interest attached to the French franc, with French Bank. Thus, A Ltd is able to acquire French francs leveraging off its ability to acquire sterling at preferential rates.

Structure

A currency swap usually takes place in three stages. The following is the procedure under what is commonly termed a 'traditional currency swap'.

1. Initial exchange of amounts in different currencies - usually set at a particular exchange rate (normally the spot exchange price on the contract date).

2. Periodic payments by each party to the other in the amounts which each party received under the initial exchange. The precise amounts of the payments being fixed by applying the rate of interest applicable to that particular currency.

3. A final exchange of currency amounts reversing the initial exchange.

Some currency swaps may omit the initial and/or the final exchange of currency. A currency swap strictly refers to the situation where the rate of interest payable by each party as part of the periodic payments is fixed for both parties. In particular circumstances there may be a "timing mismatch" where payments are made at different times or in relation to different periods by different parties. Therefore some will gain at the expense of others.

The core importance of swaps pricing models

Two centrally important points for the context of the swaps cases emerge from the foregoing analysis of swap modelling and pricing. The first is that swaps are not contracted between the parties on the basis of a single figure generated by reference to a single executory contract. Rather, each transaction is treated as made up of a number of segments which are priced separately such that a final total is reached on the basis of the calculated cost of a series of mutual obligations. It is impossible to over-emphasise the importance of the manner in which these markets conduct their business. To apply everyday rules of common law and equity without reference to the detailed factual process of creating these contracts is to overlook the risks which are considered and which are allocated as part of the transaction. Similarly, in deciding whether or not part-performed contracts can be considered differently from wholly unperformed contracts is dependent upon a financial analysis of those contracts as made up of distinct debts which are documented as part of a larger transaction.

The second point is the integral involvement of the hedging transaction within the context of creating the main transaction. The cost of hedging is necessarily priced into main transaction. The availability and cost of suitable hedging material impacts directly on the price which is charged to the buyer by means of the level of pricing that is fixed in the swap contract. The operation of the entire market is predicated on the parallel loan structure whereby market liquidity is ensured by a balance of transactions which offset with each other such that swaps books held by financial institutions are capable of being balanced and satisfactorily hedged. To deny the nexus between the hedge and the underlying contract is to is to ignore not only market practice but also the swathe of prudential regulation which requires that financial institutions effect netting and maintain capital adequacy ratios.

Options

Options are used to speculate on equity and other markets, or to manage the risks associated with such markets. The wide-spread use of derivatives over equities is a development which came comparatively late to the derivative markets. The early concentration had been upon debt markets and the foreign exchange markets.

A physically-settled, equity-based option gives the buyer the ability to have delivered to it the underlying stock which is the subject of the contract. This can be an option to buy or sell shares. Alternatively, it could be a contract to receive / pay the return on the appropriate stock exchange or index.

The two main types of option are the *put option* and the *call option*. A put option is an instrument granting the purchaser the right, but not the obligation, to sell the underlying instrument to the counterparty at a given price on a given date. Whereas a call option gives the buyer the right, but not the obligation, to acquire the underlying product at a given price on a given date.

The buyer's aim is to make premium (one-off) income. The seller's risk is that of having to deliver under the option. The buyer's bet is that the value it is entitled to buy or sell the underlying stock at, will be better than the price on the open market at the time when the option can be exercised.

Such an option may specify physical delivery of the share or it may instead specify that the cash equivalent be paid by one party to the other.

Forwards

The forward is a promise to supply a particular commodity or security at a set price on a set date (often in a set place) in the future. In the commodity markets it is usual to buy wheat, for example, at a given price in a given amount at a pre-determined time to be delivered in a given place. In the time it takes for the contract to mature (which might include the wheat to grow be harvested and shipped) the price of wheat can fluctuate wildly.

The contract, that is the right to receive the wheat at a price at a time in the agreed place, can be sold to others at a greater or lower price than that paid for it originally. The same is true, to a greater or lesser extent, of contracts entered into between private parties.

1.4 Complex derivatives: equity swaps and credit derivatives

Equity swaps

The equity swap uses the idea of the swap to enable two parties to benefit from the difference rates of appreciation between two indicators. Typically these products can cover the full range of equity products. It is possible to match the movement in the price of a particular equity, of a given equity index or of a non-equity market indicator.

Example

> The structure is usually for the payment of a fixed amount of money by one party the other in return for a floating amount. For example, X might wish to speculate on the performance of the Nikkei 225 index against LIBOR. Therefore X would seek to pay LIBOR to Y and in return receive from Y the cash equivalent of the performance of the Nikkei 225 over a given period of time. The benefit to X is a receipt of cash flow equal to the performance of the Nikkei 225 without the expense or administrative difficulties of purchasing a range of stocks appearing on the Nikkei 225. Alternatively, X could pay a fixed amount of interest on a notional amount of money in return for a payment from Y equal to the return on the Nikkei 225 from Y.

The permutations are endless. The return on any stock or index can be swapped for a fixed amount of interest or even the return on another stock or index. The more complex products, offer a basket of currencies and stocks in emerging markets as the floating rate payment in return for a fixed rate payment or a payment linked to an established market indicator such as LIBOR. Thus the calculation agent will be the person creating and calculating a bespoke index which will need to be rendered into documentary form by a legal advisor, always mindful of the potential liability attaching to the seller in respect of such complex structures.

CREDIT DERIVATIVES

Objectives

The credit derivative enables an investor to receive a return calculated by reference to the credit performance of a specified entity ("the reference entity"). By using swap, option or embedded security structures, the cash flow is calculated by reference to the reference entity's performance under specified debt or other securities obligations, or by reference to a mechanism for establishing the reference entity's credit-worth. Most commonly the investor is seeking to protect its return from an investment made in that reference entity.

The investor typically has one of three commercial objectives. The first is to create a right to receive a cash flow in the event that an entity to which the investor has a direct exposure fails to meet its payment obligations. Therefore, where the investor has subscribed for a public debt issue by the reference entity, or has participated in some structured lending by the reference entity, (variously "the underlying obligation") the investor contracts with a counterparty to pay a floating or fixed rate, while being entitled to receive a floating rate which moves in relation to the deterioration in the reference entity's performance in relation to the underlying obligation. The credit derivative is therefore able to hedge the impact of adverse movements in the reference entity's ability to perform in relation to the underlying obligation.

Where the underlying obligation is bank debt, the credit derivative enables the lender to acquire protection priced by reference to the performance of the publicly issued debt of the reference entity. Alternatively, it might be that the borrower does not have publicly issued debt. Therefore, the lender would seek to use a credit derivative priced according to the market value of the publicly issued debt of entities of similar nature in similar market segments. These alternative entities then constitute the reference entity under the credit derivative. As considered below with reference to the content of the *credit event clause*, the payment provisions would entitle the buyer of the credit derivative to receive its floating rate payment in circumstances where the reference entity's performance weakens.

For the seller of the credit derivative, the principal commercial incentives for entering into the transaction are to acquire exposure to the reference entities thus achieving a diversification of its investment portfolio. Alternatively, the seller receives a fee in return for which it is prepared to accept the risk associated with the credit derivative. In this context the use of a number of reference entities, of a type similar to the borrower in the underlying obligation, diversifies the risk beyond a straightforward exposure to a single reference entity.

The second objective is the reverse of the first. Here the reference entity itself will enter into a derivatives transaction whereby it is entitled to receive a cash flow in the event of a performance problem in relation to its own underlying obligation. Thus, the derivative counterparty is accepting the credit risk of the reference entity. This form of credit derivative might be embedded into the main underlying obligation thus providing some cash flow security for the reference entity. The commercial exigencies are similar to those relating to the lender in relation to the underlying obligation. For the seller, the payment obligation may be made by reference to a number of entities. Alternatively, the derivative may be embedded into the performance of the underlying obligation in the same way that an embedded swap would be used in relation to a eurobond issue.

The third objective is to speculate on the performance of a particular entity, or category of entities to perform on their debt or other obligations. The investor in this structure is entitled to receive, in return for a fixed rate payment,[3] a floating rate payment calculated by reference to the performance of the reference entity. For the

[3] Or a floating rate payment usually calculated by reference to a standard market indicator.

purposes of the following discussion, concentration will focus on the hedging uses of credit derivatives to provide protection against deterioration in the reference entity's credit performance. The effect of the credit derivative would then be to re-structure a debt portfolio or by acquiring exposure to the reference entity's performance. Alternatively, the utility of the credit derivative is to remove the risk involved with the credit exposure of ordinary debt, particularly given the illiquid nature of such loan transactions. The speculative context of these products makes little difference to their analysis at this stage.

In theory the credit derivative is therefore comprehensible. It is easiest to think of a credit derivative as being a type of informal insurance policy in favour of the person buying the cash flow.[4] Thus, the seller is accepting the risk of the reference entity, whereas the buyer is acquiring protection by means of the cash flow payable in the event that the reference entity defaults.

Credit derivative structures

There are three basic structures governing the payment that is made by the seller of the derivative, subject to what is said below about each form of transaction. The first mechanism is the total return structure[5] in respect of which the seller provides the cost of funding the underlying debt obligation periodically to the buyer; the buyer pays a fixed rate periodically and on maturity of the underlying debt obligation to the seller. Typically this is a swap or embedded security structure. It is on the happening of a credit event that the seller is required to pay an agreed amount to the buyer representing the value of the underlying security. Given the use of payment netting, the seller is generally only required to make payment after a credit event because that is the first time that there will be a disparity between amounts owed by the parties.

The second structure is a fixed payment by the seller on the happening of a credit event. This second structure is usually provided for in an option or barrier structure. The third payment structure is related to the scale of the movement in the credit deterioration of the reference entity's credit worth whereby the seller pays an amount which fluctuates according to the spread against the market value of the underlyer.

Confirmation issues

The form of confirmation for the credit derivatives products published by ISDA[6] offers the only market standard approach to the documentation of credit swaps.[7] Credit options are to be documented as standard options but with the addition of language to cope with the generic issues considered immediately below. There are features common to all credit derivatives which are the concern of the standard documentation. Each of the major features is considered in turn.

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[4] There are problems with the classification of the payment stream as an insurance contract which are considered below.

[5]

[6] ISDA, *Confirmation of OTC Credit Swap Transaction* (ISDA, New York, 1998).

[7] The current draft deals only with single reference entities which are not sovereign entities: therefore, counterparties are required to adapt the documentation to suit other circumstances.

First, the requirement for notice of the occurrence of a credit event. It is the approach of the ISDA standard form document that there be notice given by the buyer to the seller[8] that a credit event has occurred, thus requiring the activation of the payment provisions under the credit derivative transaction. Bound up with this issue is the availability of publicly available information necessary to indicate the occurrence of the credit event. Whether the parties require a notice of publicly available information in respect of either the reference entity or of the underlying reference asset will depend on the nature of that entity and those assets. Where the credit derivative is linked to a reference entity or a reference asset in respect of which there is little publicly available information, or where reliance on such information as opposed to other factors would not achieve the commercial requirements of the parties, it may be that the standard ISDA approach of defining the requisite publicly available information[9] is jettisoned in favour of another structure.

The credit event may be that the market value of the underlying asset (the reference obligation) deteriorates to a sufficient extent, thus indicating its reduced credit worth. Frequently this market value will be measured against a predictable market indicator, such as government securities, to indicate the deterioration in its credit worth.

The credit events identified in the ISDA credit definitions are:

- Bankruptcy
- Failure to pay
- Obligation acceleration
- Obligation default
- Repudiation of reference obligation, or moratorium
- Restructuring

Second, the issue of "materiality". As considered above, there is a need for the credit event to be sufficiently material before triggering the payment mechanism under the transaction. Again, it is at the election of the parties whether or not they decide to specify the necessity of materiality in the movement of the credit indicator. Typically, the credit indicator will be the market value of the reference asset which, in most cases, will have been issued by the reference entity (as considered above).[10] Therefore, materiality will relate to the price of that asset in the market. Alternatively, the credit indicator may refer to a particular spread on the value of that reference asset. A final option is to specify more precisely the credit events required. With reference to any particular asset or entity there will be particular events of default which will specify the materiality of the credit deterioration. In any event, the calculation agent will bear the task of identifying the necessary materiality in whichever indicator is chosen.

[8] It is assumed that market practice will be for the person requiring payment to give notice of that requirement, although where the buyer is not a suitably placed derivatives dealer it may be the seller who makes the notice.

[9] The source of the information is specified in the documentation to remove the problem of conflicting sources of information. It may be specified as a particular electronic or published source, or alternatively as being one of the parties.

[10] In identifying the material movement in the market value of the asset, the confirmation must set out the time at which that market level is to be identified, in relation to which exchange or index that level is being calculated, and whether that level is to continue for any length of time.

Third, the issue of valuation of the payment to be made under the credit swap. The date and time for valuation of the payment amount is required in the confirmation. The ISDA standard form is for quotations to be taken from market-makers. There is a need to choose between the use of bid, offer and mid-market levels from those market-makers. Having identified the levels, the precise method of calculating the market level is then necessary: whether that be an average of market levels, the highest point in the market, or the market level at a particular time.

Performance of the payment then occurs by delivery of the physical portfolio of assets required, or cash settlement.[11] The confirmation will be required to provide for a settlement mechanism in the event that the transaction cannot be performed. Where there has been a credit event, it might be that delivery of assets becomes impossible due to some market failure, or that delivery becomes illegal or impossible under the terms of the underlying reference asset. Delivery is then usually provided in the agreement to be made to the extent possible, or within a reasonable time after the contractual delivery period. Provision for the availability of default penalties for failure to deliver on time are also necessary. In the event that physical delivery is required, it may be prudent to provide for an alternative of cash settlement in the event that delivery continues to be impossible for a given period after delivery ought to have been made.

1.5 Repackaging derivatives using alternative legal analyses

Moving between options and swaps

The simplest means of re-packaging financial derivatives can be summed up in the following short section. Briefly put, if all cash-settled derivatives involve mere payments of money and reciprocal debts (of whatever kind) then it ought not to be a difficult proposition to craft alternative explanations for those various payment mechanisms. First, let us analyse the payment flows in an ordinary cash-settled option.

Payment 1	Up-front premium in an amount fixed by the option contract
Payment 2	Assuming the option is in-the-money a payment of the cash settlement amount, being the difference between the purchase price of the underlying assets specified under the option contract and the market value of those underlying assets at the valuation time.

Therefore, the option involves two payments: one a fixed amount in the form of the premium and the latter an amount which will vary according to the market value of the underlying assets at the appropriate time. The two payments are typically made on different dates. Payment of the premium will typically be expressed as being a

[11] The portfolio refers to the reference assets and other assets which are required under the terms of the transaction to be provided in settlement of the transaction.

condition precedent to the seller obligation to pay the cash settled amount. Therefore, the premium payment date will be before the cash settlement obligation is capable of being owed. Furthermore, the option is frequently used as a strategic, speculative device by the buyer and therefore would not be expected to show an immediate return.

Now, let us analyse the payment flows in an interest rate swap contract, remembering that these payments will typically be capable of being made on the same payment date although the obligations are subject to payment netting and therefore only one party will pay the balance to the other party.

Payment A	A fixed rate payment of "interest" by one party calculated by reference to some notional amount on each of a series of payment dates.
Payment B	A variable amount of "interest" by one party calculated by reference to some notional amount on each of a series of payment dates.

Where the variable (or, floating) amount is greater than the fixed rate amount, then it is surplus of that floating amount over the fixed amount which is payable by the party owing that floating amount, and vice versa.

So the re-packaging is achieved in the following way. The fixed rate payable under the swap transaction on each payment date could be separated out and booked as a series of option premiums payable under different options contracts on different premium payment dates. The floating rate payable would then need to be expressed as a variable payment calculated by reference to the difference between some underlying price (here, the market value of the underlying asset) and the price specified in the contract.

Now, let us suppose that for some reason it would be preferable for the buyer of a product who wants to receive the effect of an option to have that packaged as a swap.[12] Suppose, for example, that the buyer wants to create a series of European options which could be exercised on a series of payment dates. The premiums payable under a range of option transactions on each premium payment date could be placed in a series of fixed rate payment dates and booked not as a series of option premiums payable under different options contracts on different premium payment dates but rather as fixed rates of interest calculated by reference to some notional amount. The cash settlement amount would then need to be expressed as a variable payment calculated by reference to some underlying price (here, the market value of the underlying asset).

The fundamental question: single or multiple obligations

The initial question is whether or not a range of derivative transactions contracted between the same parties constitute one composite agreement or a number of separate

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[12] There are situations in which some entities can enter into swaps for risk management purposes but not into options or warrants for speculative purposes, for example.

agreements. This question arises at a number of levels. The ISDA Master Agreement requires that interest rate swaps, options, forwards and all other derivatives entered into between two parties are to be considered to be one contract despite there being no other reason for supposing that that is the case. Alternatively, the question arises whether an obligation to make a payment under a swap transaction in January is bound together with an obligation to make a different payment under the same swap structure six months later in June. Where those obligations can be said to constitute one agreement, netting of payments will be easier whereas a finding that there is no such link between the payments might enable the obliged party to refute its payment obligation.

So, the question stands: should financial derivatives be considered to be single, executory contracts or compilation of separate obligations? A tentative answer, based on the caselaw[13], must be that different transaction they are entirely separate agreements whereas obligations under the same transaction are linked. That separate transactions are to be considered to be separate one from another is supported by the finding in the caselaw that even where a hedging contract is entered into as part of a composite transaction, it is to constitute an entirely separate set of legal relations from the transaction which it is hedging.[14] In the alternative, it has been held that where an interest rate swap contains a series of payment obligations, the discharge of one payment does not cause the interest rate swap to be treated any differently where there are other obligations which remain outstanding.[15] This would suggest then that all of the payments owed under a single interest rate swap constitute one executory contract which is not completed until all of those obligations have been satisfied. That is in line with the classical understanding of English contract law is that a contract is based on the enforcement of some undertaking to be performed at some point in the future.[16] That elides easily into an understanding of the interest rate swap as being made up of one central obligation, rather than a number of distinct, mutual debts.

[13] See for example the decision of the Court of Appeal in *Kleinwort Benson v. Birmingham C.C.* [1996] 4 All E.R. 733;and the decision of the House of Lords in *Kleinwort Benson Ltd v. Glasgow City Council* [1997] 4 All E.R. 641.
[14] *Kleinwort Benson v. Birmingham C.C.* [1996] 4 All E.R. 733.
[15] *Kleinwort Benson v. Sandwell* [1994] 4 All E.R. 890; *Guinness Mahon & Co Ltd v. Kensington & Chelsea R.L.B.C.* [1998] 2 All E.R. 272.
[16] See Atiyah, *The Rise and Fall of Freedom of Contract'* (Oxford University Press, 1979), 176.

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Session Two

(2) Standard market documentation of financial derivatives

2.1 The documentation architecture: ISDA and beyond

2.2 Confirmations
When is a contract created?
Coping with undocumented transactions

2.3 Master Agreements
Single agreement philosophy
Payment netting
Pre-contractual representations
Events of default and termination events
Termination procedures

2.4 Schedule
Netting on insolvency; systemic risk
Bargaining for credit protection

2.1 THE DOCUMENTATION ARCHITECTURE: ISDA AND BEYOND

There is a drift towards market standards of documentation. The foremost in this field is the "ISDA" contract (produced by the International Swaps and Derivatives Association) which has slowly adapted to cover the breadth of derivatives contracts which are arranged on an OTC basis. Most of these documents are based upon the English and American systems of law and therefore the civil code jurisdictions, principally France and Germany, have begun to develop their own contracts which incorporate their commercial codes in their entirety into the contract.

This section shall concentrate on the Anglo-American versions because the aim of the course is to be an English law reference guide and because the breadth of issues covered in the Anglo-American contracts serves to illustrate all of the principal risks which are at large in this area.

There are four aspects of the documentation which are of interest here:-

1. Confirmation
2. Master Agreement (usually in a standard form)
3. Schedule to the Master Agreement
4. Credit Support documentation

Each individual transaction is connected to this Master Agreement by entering into a confirmation (the "Confirmation") which is, as its name suggests, a Confirmation of the trade which two parties have entered into by telephone, fax or telex on the dealing floors. The Confirmation is expressed to be subject to the terms of the Master Agreement. The spread of documentation is therefore inter-linked. The Confirmation sets out the details of each particular match that the parties play with one another. The link to the Master Agreement ensures that the parties are still governed by those over-arching rules of the game.

2.2 CONFIRMATIONS

WHEN IS A CONTRACT CREATED?

Offers and mere invitations to treat in marketing material

An offer to contract must be distinguished from a mere invitation to treat. An invitation to treat is an inducement to a potential counterparty to deal with person making the invitation but will not in itself be an offer. So, in an ordinary shop a sign in the window offering "Hudson's *Law on Financial Derivatives*, dead cheap at £150" would be, *prima facie*, a mere invitation to treat and not an offer to sell that book for £150. Rather, when a passer-by enters the shop and suggests to the shop-keeper her willingness to buy that book for that price, it is the passer-by who is taken to make the offer and the shop-keeper to accept it. That it is a mere invitation to treat means that if the shop-keeper refused to sell the book for £150 but rather decided to refuse to sell it for less than £200, then the passer-by would not be legally entitled to enforce a contract at £150.[17]

The key distinction between a binding offer and an invitation to treat is that an offer must be specific to the intended counterparty and not be an overly general statement. The offeror must intend to make an offer which, if accepted, would bind her to the agreement.[18] An offer of a derivative product should be distinguished from a "mere puff"; that is, a statement which is too vague to constitute an offer to enter into a contract.[19] Therefore, advertising material which merely outlines the form of product which might be available to buyers is not necessarily an offer to put in place such products either at all or on the precise terms indicated in such copy.[20]

Two examples from the derivatives context will illustrate the significance of this point. In relation to derivatives trading it is common for traders to send letters by fax to their target group of clients offering them particular forms of transaction. A more difficult, second situation would be where a financial institution devised a form of instrument which it wishes to sell to a group of market counterparties, possibly hedge funds, which the seller considers likely to buy such an investment. Suppose that the instrument is a series of identical options intended for speculation on the performance of the share of a given company against a publicly-available index of shares. Much would depend on the terms in which such marketing material were written.

Contracts created through on-going discussion

In relation to derivatives contracts, in spite of the foregoing discussion, it is not always the case that one party will make an offer to the other. Rather, parties will frequently develop derivatives transactions by virtue of ongoing discussion. Such a transaction will be a legally-binding contract provided that it can be demonstrated that the parties have come to an agreement sufficient to include all of the material terms of the transaction.[21] Once the intention to create a contract has been sufficiently established, whether or not it is possible to identify an offer separate from its acceptance, the court will enforce the contract where possible.[22] In limited circumstances, the courts will supplement the parties recorded agreement with terms necessary to achieve their commercial objectives or to give business efficacy to their transaction, as considered below.[23] In relation to the complexities of a derivatives contract it will depend on how material are the terms which have been omitted before it is possible to know whether or not it is feasible to seek to give effect to the transaction.

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[17] *Timothy v. Simpson* (1834) 6 C. & P. 499; *Fisher v. Bell* [1961] 1 Q.B. 394.
[18] *Storer v. Manchester C.C.* [1974] 1 W.L.R. 1403.
[19] *Weeks v. Tybald* (1605) Noy 11; *Lambert v. Lewis* [1982] A.C. 225.
[20] The difficulty with this analysis would be where a seller seeks to present its proposals not in the abstract but rather by specific reference to the circumstances of the target of its advertising. In any event, it is important to ensure that a clear line is drawn by the seller between marketing on the one hand and financial engineering directed specifically at the target on the other: *Bankers Trust v. Dharmala* [1996] C.L.C. 18.
[21] *Hussey v. Horne-Payne* (1879) 4 App. Cas. 311.
[22] *Brown v. Gould* [1972] Ch 53.
[23] In relation to implied contractual terms: *Pagnan v. Feed Products* [1987] 2 Lloyd's Rep. 601.

Acceptance in financial derivatives transactions: the battle of confirmations

The context in which this issue is most likely to generate problems is that in which both parties seek to accept in accordance with their standard terms, perhaps in relation to a conduct of business letter drafted in a form which that party considers to be either commercially desirable or necessary to satisfy its regulators. It may be that such an acceptance on terms might constitute a counter-offer which would be required to be accepted in turn. Where the parties proceed to perform the contract without negotiating those terms, it may be either that the parties are taken to have accepted those terms impliedly[24] or that it will emerge latterly that there was no agreement between the parties as to those issues such that there was no contract ever entered into between them.[25]

In relation to a battle of forms over the precise wording of the confirmation to be entered into between the parties, this is a frequent problem in derivatives markets, albeit that it is a problem which rarely causes difficulties provided that both parties continue to pay and receive payment without dispute. The courts have tended to look to the final salvo in the negotiation process as constituting the terms of the contract[26] – that is, unless the parties subsequently demonstrate that there was no agreement between them.[27] Equally, where the documents continue to fly between the parties' lawyers after their operations departments have begun to make payments as though the contract were complete, under the general law of contract it would not usually be permissible to alter the terms of the contract once it was in force.[28] However, given the standard market practice that the documentation of derivatives, and thus the completion of agreement of their precise terms, follows the commencement of the performance of such contracts, it is likely that such terms would be accepted as forming part of the agreement.

Role of the calculation agent

The calculation agent's role is particularly significant being the person who identifies the amounts to be paid by each party.

2.3 Master Agreements

The master agreement is the part of the documentation which sets out the manner in which the two counterparties are to conduct their derivatives business with one another. While Confirmations deal with specific transactions, the aim of the Master Agreement is to deal with the legal issues and risks which arise outside the strictures

[24] *B.R.S. v. Arthur V. Crutchley Ltd* [1967] 2 All E.R. 285.
[25] *Butler Machine Tool Co Ltd v. Ex-Cell_O Corporation (England) Ltd* [1979] 1 W.L.R. 401.
[26] *Zambia Steel & Building Supplies Ltd v. James Clark & Eaton Ltd* [1986] 2 Lloyd's Rep. 225. Cf. *Butler Machine Tool Co Ltd v. Ex-Cell_O Corporation (England) Ltd* [1979] 1 W.L.R. 401.
[27] Cf. *Johnson Mathey Bankers Ltd v. State Trading Corp of India* [1984] 1 Lloyd's Rep. 427.
[28] *Jayaar Impex Ltd v. Toaken Group Ltd* [1996] 2 Lloyd's Rep. 437.

of an individual trade. The following discussion traces the structure of the most common standard contracts.

1. Interpretation
Confirmation contradicting the terms of the Master Agreement.
Confirmation: time to negotiate

2. Payments

3. Netting

4. Witholding Tax

5. Authority

6. Capacity

7. Tax Representations

SINGLE AGREEMENT PHILOSOPHY

Importantly, the philosophy behind the International Swaps and Derivatives Association ("ISDA") documentation is that all of the confirmations entered into between two parties together with their master agreement, schedule and credit support documentation are to construed as constituting one single contract. Without such an express provision there would be no reason to consider that, for example, all of the parties interest rate swaps were to be considered to constitute a single agreement together with each individual equity option and so on. The reason for introducing this artificial link between the transactions is so that on termination of the relationship between the parties it is possible to set off all of the amounts owed between the parties and to come to one final, net sum which will meet all of their exposures one to another.[29] This is a problem which is particularly acute when dealing between jurisdictions.[30] The market's greatest concern is always for the insolvency of a counterparty which would mean, under most systems of insolvency law, that an unsecured creditor would be precluded from recovering an amounts owing to it from the insolvent party while leaving it liable to make all outstanding payments. Therefore, it is important from the perspective of the solvent party that the parties be able to reduce their exposures to a net amount across all of their transactions. The provision for the single agreement approach of the ISDA documentation consequently assuages this fear and also expresses the pre-occupation of those who created that documentation with the spectre of the insolvency of non-market counterparties.

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[29] *Stein v. Blake* [1996] 1 A.C. 243; *Morris v. Rayner Entreprises Inc.* 30th October 1997 (unreported); *Re Bank of Credit and Commerce International SA (No.8)* [1997] 4 All E.R. 568.
[30] *In re Bank of Credit and Commerce International S.A. (No.10)* [1997] 2 W.L.R. 172.

Payment netting

See Master Agreement.

Pre-contractual representations

Representations as to Powers.

The representation will usually be to the effect that:

> 'the individual(s) executing and delivering the Master Agreement (and any other documentation (including any Credit Support Document) relating to the Master Agreement) are duly empowered and authorised to do so, and it has duly executed and delivered this Agreement and any Credit Support Document to which it is a party.'

There are a number of legal issues arising from this representation:-

1. Is it a warranty or a condition of the contract?
2. What is the effect of the representation if the entity does not have the authority to contract?
3. What is the effect of the representation if the individual signatory does not have the authority to contract?

Events of default and termination events

9. Events of Default

- Failure to Pay
- Breach of Contract
- Failure of guarantee
- Misrepresentation
- Cross Default
- Credit Worth
- Corporate Restructuring
- Bankruptcy

10. Non-Fault Termination Events

- Illegality
- Tax Event
- Tax Event Upon Merger
- Credit Event Upon Merger

11. Early Termination

One-way and two-way payments

The mechanics of termination

The ISDA master agreement has a two-tier system of termination.[31] The agreement differentiates between events which arise out of some failure connected with one of the parties and events which occur as a result of circumstances beyond the control of the parties. The first category are called "Events of Default" in the ISDA Master Agreement and the latter are called "Termination Events". That nomenclature will be retained here. The procedure operates in the following way. Where there is an event of default, it is incumbent on the non-defaulting party to give notice to the other party in many circumstances specifying the event of default. Where there is a termination event it is supposed that the parties will attempt to find some way of affirming their transaction by transferring it to other subsidiary entities, or transferring it to other offices and so forth. It is only where such efforts to affirm the transaction fail within the specified grace periods that the final termination procedure is activated.

In either case the final termination procedure requires that the parties select a date on which all applicable, outstanding transactions[32] will be deemed to be terminated.[33] At such time the calculation agent calculates the amount payable in relation to each outstanding transaction on that date either to acquire replacement transactions or to compensate the parties' loss (as selected by the parties in their master agreement). Those various amounts are then set-off so that the calculation agent identifies a single amount which constitutes the net balance owed between the parties in satisfaction of all of their outstanding transactions.

Automatic termination or termination by notice?

The question whether termination should take place automatically or only on giving notice is a central issue relating to the construction of a master agreement's termination procedures. The pro forma ISDA Master Agreement operates primarily on the basis that the various termination procedures only become operational once the non-defaulting party has given notice to its counterparty that the event of default or the termination event has arisen. The onus is also on the non-defaulting party to specify the breach and so forth. However, there may be transactions conducted with counterparties which are not known sufficiently well to the non-defaulting party so that the non-defaulting party would not know that such a termination event had come into existence. One example would be the obligation that the counterparty has to maintain authorisations with its

[31] ISDA, *Multicurrency Master Agreement 1992* (ISDA, 1992), at sections 5 and 6.

[32] It may be that all outstanding transactions are set-off in this way or else it may be that only an identified group of transactions are set-off, for example if it is only interest rate swaps which have become unlawful for one or other of the parties in a given jurisdiction.

[33] Hence the importance in chapter 4 of identifying in relation to complex transactions whether they constitute single agreements or bundles of independent, separate transactions some of which are not outstanding at the time of termination.

regulator, another would be an obligation to maintain a given level of credit worth where there is no published credit rating. In either case the non-defaulting party might have no means of knowing whether or not authorisations had been maintained or whether information which had significance in relation to credit worth until the counterparty was already on the brink of insolvency.[34] The master agreement is typically constructed so that either party is able to terminate all outstanding transactions as soon as one of a range of events occurs which would indicate a *future* inability of the counterparty to perform its obligations under the master agreement. Therefore, the requirement that the non-defaulting party give notice to the defaulting party appears to be generative of problems in itself.

The solution to this problem is to provide that termination of the master agreement will take place automatically on the occurrence of one of the events of default or of the termination events.[35] This would remove the obligation on the non-defaulting party to give notice before the termination procedures would be activated. A suitable provision would provide that termination took place at the time of the event and not at the time when it was discovered subsequently. Therefore, the non-defaulting party would be able to rely upon the automatic termination of those transactions which had been outstanding at that time. If there were a collateral structure in place, then the non-defaulting party would be able to have recourse to that structure and would have a vested right in any property provided by way of collateral-under-trust or no obligation to make any repayment under a collateral-by-way-of-pledge structure.[36]

The weakness with automatic termination is that it gives the non-defaulting party no opportunity to decide whether or not it would wish the transaction to be terminated. It may be that, even though an event of default of some sort had occurred, the defaulting party is continuing to make payment under the transaction and that the transaction was profitable for the non-defaulting party. In such a circumstance, the non-defaulting party would not want the defaulting party to be able to rely on the automatic early termination provision, activate the termination procedures in the master agreement, and so end its obligation to keep making payment to the non-defaulting party. Therefore, a preferable provision might give the non-defaulting party the option whether to terminate or to affirm the transactions. This would raise issues in cases of insolvency relating to the unacceptability of allowing a solvent party to cherry-pick which transactions it would prefer to affirm and which it would prefer to repudiate. It is suggested that such a provision would not be acceptable in relation to insolvency set-off and as such ought to be excluded.[37]

"Market quotation"

The extent of the definition of "market quotation" has been considered in *Peregrine Fixed Income Ltd v. Robinson*.[38] Peregrine was a seller of derivatives which went into

[34] This would not be true for events of default such as failure to pay because the non-defaulting party would know whether or not it had received a payment which is was expecting to receive. However, where payment was delayed that party might not know that the counterparty was unable to pay rather than simply delayed in paying: in short, to misconstrue strategy for lethargy.

[35] As accepted, *infra*, in *Peregrine Fixed Income Ltd v. Robinson* [2000] C.L.C. 1328, [2000] Lloyd's Rep. Bank. 304.

[36]

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[38] [2000] C.L.C. 1328, [2000] Lloyd's Rep. Bank. 304.

liquidation at a time when it had outstanding swap transactions with Robinson, a Thai company which operated department stores in Thailand which had also gone into liquidation. Their transactions were to be subjected to the early termination procedure. The question arose as to the parties' selection of market quotation as their method of early termination. When market quotations as to the cost of replacement transactions were taken, the quotations took into account, amongst other things, Robinson's impending liquidation. Necessarily Robinson's credit worth affected the price at which the reference market makers were prepared to offer replacement transactions. Robinson contended that, further to the definition of "market quotation",[39] the parties were entitled to rely on the alternative method of "Loss"[40] in circumstances in which the use of the market quotation method would not generate a "commercially reasonable result" when calculating the final "settlement amount" under the termination procedure.[41] It was held by Moore-Bick J. that to take into account the deterioration in Robinson's credit worth was not commercially reasonable, in part because there was no credit support document in place in relation to this transaction. In deciding whether or not a party is acting in a commercially reasonable manner as calculation agent in this sense, in the absence of straightforward bad faith, his lordship expressed his view that the test of reasonableness used in judicial review of public bodies in *Associated Provincial Picture Houses Ltd v. Wednesbury Corporation*.[42] Further it was held that a party is not entitled to include within the measurement the cost of funding the payment of the early termination amount itself.[43]

However, the definition of "market quotation" provides that the quotations should be reached on any basis "that would have the effect of preserving the economic equivalent of any payment or delivery".[44] In a situation in which a credit support arrangement were in place, it could be argued that the credit worth of the counterparty would be something which would be taken into account. Indeed it would be advisable to amend the definition of "market quotation" and of "settlement amount" in the master agreement because it is likely that a default by a counterparty leading to early termination will necessarily be bound up with a deterioration in its credit worth.

"Loss"

The alternative method is that of "Loss" which, broadly put, requires proof of the loss suffered by the non-defaulting party. The definition of "loss" refers to "an amount which the [the non-defaulting party] reasonably determines in good faith to be its total losses and costs in connection with" the master agreement and terminated

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[39] *ISDA Multicurrency Master Agreement* (ISDA, 1992), s.14, "market quotation".
[40]
[41] *ISDA Multicurrency Master Agreement* (ISDA, 1992), s.14, "settlement amount"; [2000] C.L.C. 1328, [2000] Lloyd's Rep. Bank. 304, para 17.
[42] [1948] 1 K.B. 223. This is surprising given that the *Wednesbury* doctrine relates only to actions against public bodies for irrationality and not to situations in which one party to a commercial contract is seeking to make a profit at the expense of the other party to that contract. For example, how should the post-*Wednesbury* public law idea of "legitimate expectations" be adapted to fit into commercial situations, other than by private law estoppel. It is suggested that these public law doctrines ought to have no part to play in private law without more careful scrutiny.
[43] [2000] C.L.C. 1328, [2000] Lloyd's Rep. Bank. 304, para 32.
[44] *ISDA Multicurrency Master Agreement* (ISDA, 1992), s.14, "market quotation".

transactions.[45] The factors falling within that definition include "any loss of bargain, cost of funding, or at the election of such party … loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or related trading position".[46] Interestingly "Loss" does not include the parties' legal expenses.[47] Importantly, these matters "include" the things which the parties can take into account and, consequently, do not constitute a comprehensive list of the losses which might be included.[48] This method of "loss" is often easier to police than "market quotation" although it does have problems of evidence in terms of loss and also in taking into account the full range of issues which can be included in the scope of loss. The cost of unwinding hedging transactions is one matter which the non-defaulting party would usually seek to include in its calculations. Significantly, in decided cases where the contract was held to have been void, the courts have held that the cost of unwinding a hedge is not a loss which falls to be taken into account when seeking to identify the total loss which can be claimed by any one of the parties.[49] Therefore, once again, it is important to ensure that such a hedging cost, and indeed any other anticipated loss, is specified in the contract.

The question of what constitutes "loss" has been considered in *Australia and New Zealand Banking Group v. Societe Generale*.[50] Australia and New Zealand Banking Group ("ANZ") entered into derivatives with Societe Generale ("SG") in relation to Russian interest rates. SG had entered into hedging transactions with a third party which was subject to Russian banking law. The transaction between ANZ and SG was terminated early on the happening of a special event of default, akin to a form of market disruption provision, included in their agreement which related to the suspension of trading in the Russian banking market. There was a moratorium on payments in the Russian banking system which called that event of default into effect. That moratorium also prevented payments being made to SG under its hedging transaction. SG sought to bring the loss of that hedge into account as part of its "Loss" under the master agreement.

At first instance,[51] Aikens J held that the hedging transaction was unconnected to the main derivatives transaction. In part, his lordship's concern was that such a hedge may be open to abuse in that ANZ would have had no control over the amount which SG would be able to claim was lost to it by way of loss of that hedge. Indeed, SG's contention was that its sizeable gain under the derivatives transaction with ANZ was turned into a loss when the hedge was included. Therefore, the hedging cost was excluded from the calculation of loss. That decision was upheld by the Court of Appeal on appeal.[52]

On appeal SG sought to rely on two further procedural points. In seeking a new trial, SG contended that the Russian banking moratorium itself constituted an event of

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[45] *ISDA Multicurrency Master Agreement* (ISDA, 1992), s.14, "loss".
[46] *Ibid*.
[47] *Ibid*.
[48] *Ibid*.
[49] *Kleinwort Benson v. Birmingham C.C.* [1996] 3 W.L.R. 1139.
[50] [2000] 1 All E.R. (Comm) 682 (CA).
[51] *Australia and New Zealand Banking Group v. Societe Generale*, unreported, 21st September 1999, Aikens J.
[52] *Australia and New Zealand Banking Group v. Societe Generale* [2000] 1 All E.R. (Comm) 682 (CA), [2000] C.L.C. 833, [2000] Lloyd's Rep. Bank. 304, para 16.

default under the master agreement such that the amounts to be brought into account for the calculation of "Loss" were different from those agreed at first instance. They sought to distinguish between "clean" payments which assumed the proper functioning of the Russian banking system and the more (allegedly) realistic "dirty" payments which would reflect the diminished value of the payments given the Russian banking crisis which had precipitated the moratorium. A second "new point" raised by SG on appeal was that the definition of "Loss" begins with the word "including" to qualify the exclusivity which one might otherwise assume in the list of issues which are to be taken into account when calculating "Loss". On this basis SG contended that it should be entitled to bring into account the loss of its hedge, the "dirty" payments, and so forth.

The Court of Appeal, in the person of Mance LJ, nevertheless refused both of these points of appeal on the basis that it was "inherently unlikely" that ANZ would have entered into a "futures contract" [sic] on the basis that it shared the risk of a "simple collapse" in SG's hedge. In effect, the two points on appeal were capable of being disposed of using the analysis which Aikens J had used at first instance. Therefore, to bring the cost of such a hedge within the transaction it would be important that SG have included expressly some provision as to its hedging strategy.

The Court of Appeal's decision in *Australia and New Zealand v. Societe Generale* is in similar terms to the decision of the Court of Appeal in *Kleinwort Benson v. Birmingham C.C.*[53] was not referred to by the Court of Appeal. As considered in previous editions of this book[54] in relation to the *Birmingham* appeal, it would be essential for the inclusion of the cost of losing or unwinding a hedge within the terms of the documentation as something the parties intended to include within their definition of "loss". Otherwise, the courts will evidently not accept it being something which the parties can include. That is in spite of the mention of the "loss or cost incurred as a result of its terminating, liquidating, obtaining or re-establishing any hedge or related trading position" as something which is included in the ISDA definition of "loss" for precisely these purposes.[55] The courts are maintaining a common lawyer's notion of foreseeability here and not applying the terms of the ISDA master agreement. The decision of the court at first instance in *Australia and New Zealand v. Societe Generale* was that it was the Russian banking moratorium which caused the loss by preventing payment and not the loss of the hedge itself; it is suggested that the dividing line between those things is very narrow indeed.

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[53] [1996] 3 W.L.R. 1139, [1996] 4 All E.R. 733.
[54] Hudson, *The Law on Financial Derivatives*, 2nd edition (Sweet & Maxwell, 1998), 58. That discussion is reproduced at para 2-117 of this edition.
[55] *ISDA Multicurrency Master Agreement* (ISDA, 1992), s.14, "loss".

2.4 Schedule

The schedule to the master agreement is the arena in which the counterparties seek to control their legal risk. This is the portion of the documentation which is negotiated between the parties to amend the standard provisions of the pro forma master agreement. The usual method of negotiating these documents is an exchange between the parties of their own standard form schedules which seek the maximum advantage for the institution involved. The major categories of legal risk dealt with in the schedule are: credit risk, alteration in corporate structure; insolvency; default under the terms of the transaction and tax.

Netting on insolvency; systemic risk

The standard form of set-off provision in ISDA's suggested documentation is in the following format:

"Any amount ("the Early Termination Amount") payable to one party (the Payee) by the other party (the Payer) [under the Termination Provisions in the Master Agreement], in circumstances where there is [one party which has contravened one of the Automatic Termination Provisions] or [one party in the case where an Automatic Termination Provision] has been contravened, will, at the option of the party ("A") which is not the party which has contravened the Automatic Termination Provisions (and where there has not been prior notice to that contravening party), be reduced by its set-off against any amounts ("the Other Agreement Amount") payable (whether at such time or in the future upon the occurrence of a contingency) by the Payee to the Payer (irrespective of the currency, place of payment or the place where the obligation was entered onto the books of either party) under any other agreement(s) between the Payee and the Payer or instrument(s) or undertaking(s) issued or executed by one party to, or in favour of, the other party (and the Other Agreement Amount will be discharged promptly and in all respects to the extent it is so set-off). A will give notice to the other party of any set-off effected under this provision.

"For this purpose, the Early Termination Amount (or the relevant portion of such Early Termination Amount) may be converted by A into the currency in which the other is denominated at the rate of exchange at which such party would be able, acting in a reasonable manner and in good faith, to purchase the relevant amount of such currency.

"If an obligation is an unliquidated amount, A may in good faith estimate that obligation and set-off in respect of the estimate, subject to the relevant party accounting to the other when the obligation is ascertained.

"Nothing in this provision shall be effective to create a charge or other security interest. This provision shall be without prejudice and in addition to any right of set-off, combination of accounts, lien or other right to which any party is at any time otherwise entitled (whether by operation of law, contract or otherwise)."

The caselaw on close-out netting

This issue of matured obligations arose in the House of Lords decision in *British Eagle International Airlines -v- Air France*[56] where it was held that the

[56] (1975) 2 All ER 390 HL

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.[57] 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.[58]

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*[59] 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[60] created before the person asserting set-off had notice of the insolvency of the liquidated party.[61]

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 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*[62] 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.

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[57] 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.
[58] The only qualification to this argument, under the executory analysis, is that no asset must have passed under the contract to the insolvent.
[59] [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.
[60] *Bank of Credit and Commerce International S.A. v. Prince Fahd Bin Salaman Abdul Aziz Al-Saud* [1997] B.C.C. 63.
[61] *Stein v. Blake* [1996] 1 A.C. 243.
[62] 30th October 1997 (unreported).

In both joint appeals deposits were provided as security for loans to the respondent borrower.[63] 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.[64] 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*.'

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

[63] 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.
[64] See *In re Bank of Credit and Commerce International S.A. (No.10)* [1997] 2 W.L.R. 172.

take those obligations into account in calculating a final netted termination amount.[65]

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.*[66] 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.[67] 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.

Bargaining for credit protection

Credit protection is considered in greater detail in the next section.

Corporate Restructuring in the Counterparty

The events which should be covered with reference to a partnership include reconstitution, incorporation, or admission or withdrawal of a partner.

The events which should be covered with reference to a trust structure include reconstitution, incorporation, or admission or withdrawal of a trustee; or dissolution of a pre-ordained amount of the trust fund.

The events which should be covered with reference to a company include consolidates or amalgamates with another entity; or merges with or into another entity; or transfers all or substantially all its assets to another entity; or reorganises, incorporates, reincorporates as another entity; or reconstitutes into or as another entity; and, at the time of such consolidation, amalgamation, merger, transfer, reorganisation, incorporation, re-incorporation, or reconstitution; or where the counterparty effects a re-capitalisation, leveraged buy-out, or other similar highly-leveraged transaction; and substitute in the contract the counterparty (in its new form) or any resulting, surviving, transferee, reorganised, or re-capitalised entity.

[65] The standard ISDA wording expressly includes specified transactions and specified entities.
[66] [1987] Ch. 150.
[67] See for example *Haleowen Presswork & assemblies Ltd. v. National Westminster Ltd.* [1971] 1 Q.B. 1; [1972] A.C. 785, *per* Buckley L.J..

3

Session Three

(3) Collateralisation and taking security

3.1 Standard mechanisms for taking security

Pledge
Trust
Charges, fixed and floating
Lien
Guarantee
Letter of comfort

3.2 Collateralisation

ISDA Credit Support Annex
Pledged collateral
Lending collateral
Re-hypothecation and activation

3.1 Standard mechanisms for taking security

Pledge

A pledge, as ordinarily understood,[68] would involve the owner of property – in the circumstances of a derivatives contract, the counterparty required to post collateral – parting with possession of the property by delivering it to the secured party without giving that secured party the right to deal with that property as though its absolute owner.[69] The secured party is prevented from dealing with the property as its absolute owner until such time as its proprietary rights crystallise, typically by reason of the counterparty's failure to pay under the main transaction or as otherwise provided for in the pledge agreement. In the event that those rights crystallise, thus vesting almost absolute title in the secured party, the secured party is entitled to sell the pledged asset to make good the counterparty's failure in performance.

However, the secured party is described as having "*almost* absolute title" in these circumstances because any surplus generated by the sale of the pledged assets over the amount owed by the counterparty must be paid to the counterparty and as such it is therefore not quite accurate to suggest that the secured party is absolute owner of the pledged assets at that time. The secured party will be trustee, it is suggested, of any such surplus between the time it is received and its payment to the counterparty. Where the surplus has not been segregated from the amount which the secured party is entitled to retain in discharge of the counterparty's failure to pay, then the entire sale proceeds of the pledged assets are held on trust by the secured party in proportion to the amount to which each party is entitled.[70] It is important that the pledgee's rights are to apply the property to discharge the pledgor's obligations and are not a transfer of absolute title because such a transfer of title would entitle the pledgee to retain any surplus in the value of the property over the debt owed to the pledgee.[71]

The foregoing discussion has assumed that form of pledge typically discussed by commercial lawyers.[72] However, in financial derivatives transactions it is frequently the case that credit support agreements will express the pledgee as being in fact the absolute owner of the property provided by way of collateral. Therefore, the form of pledge used in derivatives transactions will be an atypical form of pledge which is more akin to an outright transfer of title subject to a purely personal obligation to return property of a like kind or a similar value in the event that the pledgor does perform its obligations under the derivatives contract.[73]

What is most significant is that the precise rights of the secured party will turn on the manner in which they are expressed by the pledge agreement.

[68] The most common example of a pledge would be an arrangement with a pawnbroker.
[69] *The Odessa* [1916] 1 A.C. 145.
[70] *Re Goldcorp* [1995] 1 A.C. 74, *infra*.
[71] *Re Hardwick, ex p Hubbard* (1886) 17 Q.B.D. 690. Cf. *Carter v. Wake* (1877) 4 Ch. D. 605; *Fraser v. Byas* (1895) 11 T.L.R. 481.
[72] Worthington 1996; Goode 1997.
[73]

There is an issue surrounding the use of bonds and other commercial paper as collateral. The dematerialisation of such financial obligations has had the effect that the question of asserting title over those securities becomes counter-intuitive. The problem, at root, is as follows.[74] The publicly-issued debt market has developed a pragmatic response to the dangers of physical bearer securities being misappropriated from their rightful owners. Much in the same way that cash can be stolen and spent (usually) anonymously, bearer securities can be sold or lost and then misapplied. The market developed the use of global notes which represent rights in the bearer securities by means of a title registration system. The bearer securities themselves are held physically in secure vaults so that no subscriber actually receives their physical security. The global note and the debt issue typically express the securities to be bearer securities. Each subscriber to the issue is required to register their title with the custodian. The commercial risks associated with physical custody are thus removed.

The legal conundrum that is created surrounds the creation of other rights in the global-note-bearer-securities. If the registered title-holder in that security declares itself a trustee of the security for another person under English law, that other person will acquire the rights of a beneficiary under English trusts law against the title-holder. What is not clear is what rights will that other person have to enforce rights in the security which is expressed to exist in the jurisdiction where the bearer notes are physically deposited, if the system of law applicable in the situs of the deposit does not recognise the rights of a beneficiary under an English trust but only the property rights of the registered title-holder. Such unenforceability of the trust structure would render ineffective any collateral agreement based on a trust over the bearer notes.[75]

The further problem of English trusts law which arises is the following. For a valid express trust under English law the property comprising the trust fund must be identifiable.[76] Therefore, where a beneficiary attempts to assert rights under the law of trusts over a trust fund comprising a portion of a total holding of intangible securities, that trust will not be found valid unless the specific securities at issue are identified.[77] Therefore, the trust fund would similarly fail.[78] There is authority, however, that with reference to a trust declared over a portion of a total holding of ordinary shares, there is no need to segregate those shares which are to be held on that trust.[79] It is suggested that this latter approach will only be effective where there is, for example, no issue of insolvency and a number of creditors seeking to claim rights in the shares which is

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[74] For an extended discussion of this issue of global custody see Benjamin, *The Law on Global Custody* (Butterworths, 1996).

[75] See, for a general commercial analysis of this issue Duffett, “Using trusts in international finance and commercial transactions” [1992] *Journal of International Planning* 23.

[76] *Re Goldcorp* [1995] 1 A.C. 74; *Re London Wine (Shippers) Ltd* [1986] P.C.C. 121; cf.: Goode “Ownership and Obligation in Commercial Transactions”, (1987) 103 L.Q.R. 433; Ryan, “Taking Security Over Investment Portfolios held in Global Custody”, [1990] 10 J.I.B.L. 404 .

[77] [1995] 1 A.C. 74.

[78] As Benjamin sets out, there is no obligation typically on the depositary to segregate the assets in the manner which English trusts law would appear to require: Benjamin, *The Law on Global Custody* (Butterworths, 1996), 131. See also Prime, *International Bonds and Certificates of Deposit* (Butterworths, 1990), 4 *et seq.* on the role of euro-currencies in this context.

[79] *Hunter v. Moss* [1994] 1 W.L.R. 452, [1994] 3 All E.R. 215; see also (1994) 110 L.Q.R. 335. Also possibly *Re Stapylton Fletcher Ltd* [1944] 1 W.L.R. 1181 would be of some support as to the lack of need for segregation, although the case relates only to legal interests in the chattels at issue.

greater than the number of shares available to be distributed among them.[80] In relation specifically to money, which might be thought to be the most obvious example of property which is inter-changeable, there is a requirement that the fund be segregated within a bank account before any trust can be imposed equal to a liquidated sum held with other moneys in a bank account.[81]

There is one final issue as to the role of the custodian of the global note as a trustee in itself. A trustee may or may not be appointed in respect of the global note. Further, the custodian may not be expressed to be a trustee and yet appear to have the trappings of a trustee in a jurisdiction where the trust concept is not recognised. The issue as to the enforceability of trustee obligations is therefore a vexed one. This issue arises generally with reference to bond issues and in particular in respect of depositary receipts.[82]

Charges, fixed and floating

By contrast with a fixed charge, in which the rights attach to identified property, a floating charge has a defined value which takes effect over a range of property but not over any specific property until the point in time at which it crystallises.[83] A floating charge is different from a fixed charge in that the chargor is entitled to deal with the property over which the charge floats without reference to the chargee, unlike a fixed charge which restrains the chargor from dealing with the charged property without accounting to the chargee.[84]

A floating charge will usually be identified by reference to the following factors:

> '(1) If it is a charge on a class of assets of a company present and future; (2) if that class is one which, in the ordinary course of business of the company, would be changing from time to time; and (3) if you find that by the charge it is contemplated that, until some future step is taken by or on behalf of those interested in the charge, the company may carry on its business in the ordinary way so far as concerns the particular class of assets I am dealing with.'[85]

Therefore, a floating charge enables the owner of that property to continue to use it as though unencumbered by any other rights. The only difficulty then arises on how to deal with the property once the chargee seeks to enforce its rights. In this sense there is a narrow line in many cases between a floating charge and either a fixed charge of a

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[80] See *Westdeutsche Landesbank v. Islington LBC* [1996] A.C. 669, [1996] 2 All E.R. 961 *per* Lord Browne-Wilkinson approving the decision in *Re Goldcorp, op cit.*.

[81] *Mac-Jordan Construction Ltd v. Brookmount Erostin Ltd* [1992] B.C.L.C. 350; *Re Jartray Development Ltd* (1982) 22 B.L.R. 134; *Rayack Construction v. Lampeter Meat Constructions Co Ltd* (1979) 12 B.L.R. 30; *Nestle Oy v. Lloyds Bank plc* [1983] 2 Lloyds Rep. 658; *Concorde Constructions Co Ltd v. Colgan Ltd* (1984) 29 B.L.R. 120. Cf.: *Swiss Bank v. Lloyds Bank* [1979] 2 All E.R. 853, affirmed [1981] 2 All E.R. 449, whereby a claim to an unsegregated fund might nevertheless give rise to a charge.

[82] See Benjamin, *The Law on Global Custody* (Butterworths, 1996), 41 *et seq.*.

[83] *Re Yorkshire Woolcombers Association* [1903] 2 Ch. 284; *Illingworth v. Houldsworth* [1904] A.C. 355; *Evans v. British Granite Quarries Ltd* [1910] 2 K.B. 979; *Re Bond Worth* [1980] 1 Ch. 228.

[84] *Royal Trust Bank v. National Westminster Bank plc* [1996] B.C.C. 316.

[85] *Re Yorkshire Woolcombers Association Ltd* [1903] 2 Ch. 284, 295, *per* Romer LJ.

trust. For example, a provision which purported to create a trust over "the remaining part of what is left" from a fund would not be sufficiently certain to create a trust nor a fixed charge because the identity of the precise property at issue could not be known.[86] The alternative analysis of such provisions is then that they create a mere floating charge such that the person seeking to enforce the arrangement would acquire only a right of a given value which related to a general pool of property without that right attaching to any particular part of it. Such a structure would be weaker than a proprietary trust right in the event of an insolvency because the rightholder could not identify any particular property to which the right attached.[87] One means of identifying the difference between a fixed and a floating charge is the following one:

> 'A [fixed, or] specific charge … is one that without more fastens on ascertained and definite property or property capable of being ascertained and defined; a floating charge, on the other hand, is ambulatory and shifting in its nature, hovering over and so to speak floating with the property which it is intended to effect until some event occurs or some act is done which causes it to settle and fasten on the subject of the charge within its reach and grasp.'[88]

What, perhaps, that statement does not encapsulate however is the acid test for the distinction between floating and fixed charges: whether or not the chargor is entitled to deal with the property as though the charge did not exist, something which is a feature of a floating but not a fixed charge.

GUARANTEE

The distinction between guarantees and indemnities

A guarantee is a promise made by a guarantor to a creditor to honour the performance of the obligations of some other person, the primary debtor, to that creditor. An important distinction must be made between a guarantee and an indemnity. A guarantee is a form of secondary liability in that the guarantor is only liable to make payment if the primary debtor would have been liable to make payment. In such a circumstance, the guarantor is assuming the obligation of the primary debtor where that primary debtor defaults in performance of its obligations. By contrast, an indemnity is a promise to make good any loss which the creditor suffers under a transaction whether or not the primary debtor would have been liable to make payment. In this latter instance, it is the creditor's loss which is being compensated in general terms and not the primary debtor's failure to perform some obligation which it was at law and in equity obliged to perform. The distinction is a matter of construction of the terms of a contract.[89]

The distinction is significant because a guarantee is required to be made in writing[90] whereas an indemnity has no such formality in its creation.[91] Under statute,[92] 'No

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[86] *Sprange v. Bernard* (1789) 2 Bro CC 585.
[87] *Re Goldcorp* [1995] 1 A.C. 74.
[88] *Illingworth v. Houldsworth* [1904] A.C. 355, 358, *per* Lord Macnaghten.
[89] *Yeoman Credit Ltd v. Latter* [1961] 1 W.L.R. 828; *Heald v. O'Connor* [1971] 1 W.L.R. 497; *General Produce Co. v. United Bank Ltd* [1979] 2 Lloyd's Rep. 255.
[90] Statute of Frauds 1677, s.4.

action shall be brought … whereby to charge the defendant upon any special promise to answer for the debt, default or miscarriage of another person …' unless there is evidence of that promise in writing.[93] Therefore, the contract of guarantee may be created orally provided that it is evidenced in writing subsequently.

Guarantees forming part of a larger transaction

The foregoing formalities apply to guarantees which stand alone and not to guarantees which form part of a larger transaction. The credit support documentation in financial derivatives transactions is intended to constitute one single agreement together with the master agreement, its schedule and all attendant confirmations. In consequence, a guarantee executed as part of a master agreement would potentially be part of a larger transaction. In circumstances in which an intermediary introduced clients to a stockbroker on condition that the intermediary would receive half the profits or bear half the losses, as applicable, it has been held that such a guarantee to meet those losses payable by the stockbroker constituted part of a larger transaction.[94]

Therefore, a guarantee to make payment under a range of derivatives transactions connected together with the guarantee by a master agreement might constitute such an agreement which is part of a larger agreement. However, typically the guarantor will not perform any part under the derivatives master agreement other than extending a guarantee and therefore, it is suggested, merely providing a guarantee ought not in substance to constitute that guarantee part of a larger transaction because the guarantor receives no other benefit nor bears no other burden under that master agreement to constitute it in truth part of a larger agreement. To make a guarantee appear to be more likely part of such a larger agreement it is suggested that it be expressed in that agreement that the guarantor's participation alters the funding of the transaction by, *inter alia*, reducing the credit risk component and thereby the cost to the primary debtor of the transaction.

Guarantees in variable amounts; notice

It is usual for guarantees in derivatives transactions to be guarantees to pay variable amounts, depending on the obligations of the primary debtor at the time of its failure to pay or perform. The master agreement usually provides that notice must be given of any obligation to make payment whether in activating an event of default[95] or in claiming default interest.[96] Such provisions create difficulties in relation to the legal treatment of guarantees. Where a requirement of notice is contained in the contract before payment under such a guarantee is required, if such notice is not given within a period identified in the contract then the guarantor's obligation to pay will expire.[97]

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[91] *Birkmyr v. Darnell* (1704) 1 Salk. 27; *Argo Caribbean Group v. Lewis* [1976] 2 Lloyd's Rep. 289.
[92] *Ibid*.
[93] That is so whether the promise arises in contract or in tort: *Kirkham v. Marter* (1819) 2 B. & Ald. 613.
[94] *Sutton & Co. v. Grey* [1894] 1 Q.B. 285.
[95] ISDA, *ISDA Multi-currency Master Agreement* (ISDA, 1992), s.5(a)(i).
[96] ISDA, *ISDA Multi-currency Master Agreement* (ISDA, 1992), s.2(e).
[97] *National Westminster Bank plc v. Hardman* [1988] F.L.R. 302.

Where there is no expiry date on that obligation then the obligation will not expire,[98] other than under the Limitation Act in the ordinary course of events. Similarly, if the expiry period operates only to calculate the size of the guarantor's obligation and not to decide whether or not it is liable at all, then such an expiry will not affect the guarantor's obligation to make payment under the contract of guarantee.[99]

Letter of comfort

Of little comfort …

3.2 Collateralisation

ISDA Credit Support Annex

The structure of the Credit Support Annex

The operation of the Annex depends on the party requiring transfer of the collateral assets to call for them. Thus the party requiring posting of collateral must make a demand for a transfer of the amount of assets equal to the difference between the Credit Support Balance (the amount outstanding under existing, relevant transactions) and the Credit Support Amount (the amount then pledged as collateral).[100] The obligation on the transferor is then to transfer the requisite assets. Where those assets are cash,[101] transfer must take place within one local business day of effective notification of the demand for collateral.[102] In the case of securities being provided as collateral,[103] transfer must take place within one local business day of the ability of settlement of a trade to take place in those securities in ordinary market circumstances.[104] The same analysis applies where there is more collateral pledged than there is exposure under the transactions at that time.

One significant issue is the calculation of amounts to be transferred under the Annex. The structure adopted by ISDA is for the parties to select a "valuation agent". The default valuation agent in the Annex is the party making the demand for the provision or return of collateral, as appropriate.[105] This appears to raise the possible problem of contradictory claims for delivery where both sides consider the market value of the outstanding obligations supports their claim for transfer of collateral assets. This problem has been anticipated by the ISDA committee and where disputes arise "reasonably"[106] the party raising the dispute is required to notify the other party and

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98 *Re Crace* [1902] 1 Ch. 733, *infra.*
99 *Bank of Credit and Commerce International SA v. Simjee* (unreported, 3rd July, 1996).
100 ISDA, *Credit Support Annex* (ISDA, 1995), para. 2(a).
101 Provision is made for the calculation of an appropriate rate of interest to attach to such provision of currency: ISDA, *Credit Support Annex* (ISDA, 1995), para. 10.
102 Usually to be made by 1.00pm GMT on a local business day.
103 The Annex is silent as to title to dividends and other distributions made in respect of securities extended as part of the collateral assets.
104 ISDA, *Credit Support Annex* (ISDA, 1995), para. 10.
105 ISDA, *Credit Support Annex* (ISDA, 1995), para. 11(c).
106 ISDA, *Credit Support Annex* (ISDA, 1995), para. 4(a).

the counterparties are then required to attempt to reach an agreement between themselves. If that proves impossible, the valuation agent is required to perform the mathematics again. The approach of the Annex, although it is not explicit on this point, is that the valuation agent's calculation will be final. Given that there is no express term with that straightforward result,[107] it will still be open to the disputing party to commence legal proceedings to protest at the result arrived at by the valuation agent. On a commercial basis, it is important for the parties to select an appropriate valuation agent. Most counterparties will seek to be valuation agent themselves. The Annex provides that the parties are required to act in good faith and in a commercial reasonable manner: including the valuation agent.[108]

Pledged collateral & Lending collateral

In a pledge structure the party posting collateral transfers title outright to the assured party. The assured party, on receiving the collateral, is entitled to treat that property entirely as its own and therefore to sell it, mortgage it or deal with it in any way that an absolute owner would be entitled to behave with it. The only obligation which the assured party bears is to return property of a like kind if its exposure to the counterparty under the transaction falls. That obligation to return property of a like kind means that the original property posted as collateral does not have to be returned; rather, it is only similar property or even cash which is to be returned.

In a retention of title structure, the assets would be lent only by the party posting collateral. Therefore, the party posting collateral does not surrender title in those assets to the assured party. Rather the assured party will acquire possession of those assets and only a lien over those assets. That means that the assured party has possession of the assets but no rights of ownership whether to sell that property, mortgage it or deal with it in any other way. A lien may crystallise into a proprietary right if the contract between the parties containing the lien entitles the assured party to convert those assets once the counterparty has failed to perform the relevant obligations under the derivatives agreement, or where it has committed some event of default under the master agreement. However, in the absence of any breach of the agreement or in the absence of the commission of any event of default, the party posting collateral retains ownership rights in the property.

In a trusts structure, a trustee would hold the posted collateral on trust such that both parties had some, contingent beneficial right in the property. The assured party's beneficial right would be contingent on the performance of the counterparty such that the assured party's right would not vest in it (or, crystallise) until there was some default committed by the counterparty. Similarly, the counterparty's right would vest at the time its obligations to the assured party were satisfied. The principle difficulty with this structure is considered below in relation to those question of taking property rights over bonds issued under a global note.

Which of these analyses is applicable to any set of factual circumstances is dependent on the choice which the parties make in structuring their credit support documentation. For

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[107] It appears to be implied by the absence of any mechanism for appeal.

[108] ISDA, *Credit Support Annex* (ISDA, 1995), para. 9(b).

example, the ISDA credit support annex pre-supposes that the parties will make such an express selection in their documentation.

Clearly, some of these issues are general commercial issues and some of them are pure legal issues. In the whole though, they are issues which a lawyer must consider and deal with in framing collateral documentation. This section will first consider the commercial issues covering the provision and taking of collateral. Then it will consider the legal issues surrounding collateral. Finally, it will examine some of the regulatory and inter-party alternatives to *ad hoc* collateralisation, as practised in the market currently, which produce the same credit amelioration effect.

Re-hypothecation and activation

Where there is a default in the terms set out by the master agreement, that will constitute a default under the Annex, thus triggering the termination procedures considered above.[109] The reference to market quotations and loss in respect of the calculation of the single amount required to settle the termination is provided to incorporate the collateral remaining on deposit under the Annex.[110] Where provision of collateral assets is late due to some dispute, there is provision for the payment of default interest.[111] There is no general provision as to payment of interest for late delivery of collateral assets in ordinary circumstances.[112]

The parties are then required to make elections as to the remaining provisions. The parties must select the threshold below which no transfer will be made to top-up or reduce the level of collateral deposited. Commercially, there will be a *de minimis* level below which it is simply too expensive to transfer small amounts of collateral. Alternatively, it may be that the particular property provided is denominated in amounts of value which make transfer of specific amounts impossible. In this circumstance, the parties select a level at which transfer obligations will be rounded up or down to account for the denomination of assets supplied.

The Annex itself does not provide for the allocation of any security interest in any property. This frees the parties from any formalities as to the creation and registration of security interests. The Credit Support Deed does provide for security to be allocated, with the deed format ensuring that the base level of formality is satisfied and the need for contractual consideration dispensed with. The deed provides, in its standard form, that the chargee receives a “first fixed legal mortgage on all Posted Collateral” with “full title guarantee”.[113]

A custodian is appointed to hold the collateral assets. While there is no explanation of the custodian’s legal nature, it appears from what is said below that the custodian must be a trustee holding the collateral assets on the terms of the deed, which forms the terms of the trust, as a segregated fund. Where one of the parties, or its affiliates,

[109] ISDA, *Credit Support Annex* (ISDA, 1995) , para. 6, *infra.*
[110] ISDA, *Credit Support Annex* (ISDA, 1995), para. 6.
[111] ISDA, *Credit Support Annex* (ISDA, 1995), para. 9(a).
[112] Therefore, it is assumed that the provisions in the master agreement as to default interest should have effect by virtue of appropriate link of the two documents.
[113] ISDA, *Credit Support Deed* (ISDA, 1995), para. 2.

is to act as custodian, this would appear to raise conflicts between that entity's personal and fiduciary capacities. The documentation must delineate exactly the obligations of the custodian and the extent of its ability to benefit from the trust, particularly where the custodian is also a market-maker in the underlying derivatives transaction, seeking to profit from the structure created.

The reference to "posted collateral" is a mechanism to identify the floating category of assets which will constitute the collateral assets at any time. It also ensures that there is certainty as to the assets which are caught by the deed. To ensure that there is a valid trust of the property provided, the custodian is required to open an account in which only the collateral assets are held.[114] Thus, the assets are "segregated" as a separate fund over which the chargee will be able to establish secured, proprietary rights.[115] It is provided that the chargor retains all rights to distributions and voting privileges attaching to any pledged securities[116] until a default event which vests title in those assets in the chargee.

The collateral is then used in the event of a default under the master agreement and/or confirmations to set-off the amounts owed to the chargee to the extent only of those amounts. There remains at that stage the issue of valuing cross-currency obligations by the non-defaulting party.[117]

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[114] *Re Goldcorp* [1995] 1 AC 74.
[115] ISDA, *Credit Support Deed* (ISDA, 1995), para. 6(c).
[116] ISDA, *Credit Support Deed* (ISDA, 1995), para. 6(d).
[117] ISDA, *Credit Support Deed* (ISDA, 1995), para. 8. This provision is expressed to outwith the ambit of ss.93 and 103 of the Law of Property Act 1925.

Back to basics …

Thinking about taking security in financial transactions

The key issue here is simply to reflect on what we know about law, and about the management of risks through legal techniques, and see behind the veneer of complexity which attends derivatives agreements so that we understand how those ordinary legal models apply to the individual transaction.

For example, in relation to collateralisation the real questions are these:

- Do we have any property which we currently own absolutely which we may keep in the event that the counterparty does not perform: yes or no?
  If yes, we have only to consider the value of that property compared to the value of our exposure to the counterparty.
  If no, then what do we have …
- Do we have:
  - any equitable rights under an ordinary express trust in any property[118], or
  - any equitable rights under a *Quistclose* trust; or
  - ownership of property as a mortgagee (mortgage), or
  - a right to seize identified, segregated property as a chargee (fixed charge), or
  - a right to seize property of a given value from a pool of property (floating charge), or
  - a contractual right to apply to the court to seize property (lien), or
  - do we have only personal claims against the counterparty?
- If we have only personal claims, are those claims in the form of:
  - A mere debt claim against the counterparty, or
  - A mere claim to breach of contract against the counterparty, or
  - A claim under a guarantee against some third party.
- Ordinary collateral structures under the Credit Support Annex provide nothing more than debt claims – the only advantage being the reciprocal nature of the payment obligations which can be (a) netted; (b) written off on a net basis against other obligations to make payment; and (c) mollification through the use of hedging strategies.
- In short, these are ordinary legal questions requiring ordinary legal answers.

Prime brokerage structures

Many derivatives transactions are conducted through intermediaries. Prime brokerage structures trade on the credit work of an intermediary financial institution which is used by transacting parties precisely because that intermediary has a better credit rating than the transacting parties. This is sometimes inaccurately referred to as “lending the institution’s balance sheet” to the transacting parties (no loan in fact takes place although the transacting parties can rely on the intermediary’s undertaking to perform).

The real issue is then: what if the intermediary fails to perform? The structures are as follows:

[118] Assuming segregation of the property and not assuming *Quistclose* trust structures at this juncture.

- No structure – rely on breach of contract
- Adapt event of default language in the master agreement to accommodate intermediary's failure to perform
- Use a collateral structure whereby each party is obliged to pay into a bi-cameral collateralisation account so that only net obligations are at risk
- Require the intermediary to hold assets on trust to which the transacting party may have recourse in the event of failure to perform*
- Use a guarantee from the intermediary and thus rely on its credit rating*
- Rely on the intermediary's role holding a range of assets and transactions for the transacting party which can achieve a wider set-off than simply payment under this transaction**

**the problem with these two structures will be commercial: i.e. how far will the intermediary go for this business.*
***this depends on whether the intermediary is acting on a one-off basis or in relation to a large range of business.*

The further dimension will be securities lending, clearing, settlement and custody services offered by the prime broker: these further contractual obligations will present other opportunities for taking security and/or for committing breaches of contract.

The further issues are then:

- Does the documentation tie together all three parties (including the intermediary)?
- Does the documentation tie together the derivatives transactions with non-derivatives transactions?

4

Session Four

(4) Common legal issues with financial derivatives contracts in practice

4.1 Restitution and termination of swaps agreements

The English local authority swaps cases
Personal claims for restitution (money had and received)
Trusts implied by law
Availability of compound interest
Collateralisation and credit support now?

4.2 Performance of financial derivatives agreements

Frustration
Severance

4.3 Validity of derivatives contracts

Capacity and authority issues
Gaming contracts
Insurance contracts

4.4 Litigation case study – *Bankers Trust v. Dharmala*

Undue influence
Misrepresentation
Dishonest assistance in a breach of duty
The role of the "house bank"
The inter-action between financial regulation and the common law

4.1 Restitution and termination of swaps agreements

The English local authority swaps cases

The local authority swaps cases revolve around the joined appeals of Westdeutsche Landesbank Girozentrale proceeding against the London Borough of Islington ('*Islington*')[119] and Kleinwort Benson proceeding against Sandwell Borough Council ('*Sandwell*')[120]. There are another important group of appeals which proceeded on a parallel course but raised slightly different points of law as to the availability of defences to restitutionary and equitable claims brought in relation to the avoidance of the interest rate swaps. It was the *Islington* appeal which was pursued to the House of Lords and which forms the core of the following discussion as a consequence. Of the two hundred writs that were served in wake of the judgement of the House of Lords in *Hazell*, two of these appeals were brought by Kleinwort Benson against Birmingham City Council ('*Birmingham*')[121] and against South Tyneside Metropolitan Borough Council ('*South Tyneside*')[122] which examine the development of defences to the restitutionary and equitable claims brought. All this is apart from the cases on capacity of local authorities to enter into transactions, *Hazell v. Hammersmith & Fulham* [123]('*Hazell*') and the contracts for differences cases, *Morgan Grenfell v. Welwyn Hatfield DC and others*[124] ('*Welwyn*').

The decision in Westdeutsche Landesbank v. Islington, in outline

The leading speech in the House of Lords in *Islington* was delivered by Lord Browne-Wilkinson, with whom Lord Lloyd[125] and Lord Slynn[126] concurred on all points, but with Lord Goff and Lord Woolf dissenting on the availability of compound interest. In short, the majority view was that: compound interest is available only in circumstances where the claimant has an equitable proprietary interest of the property in respect of which compound interest is claimed; there was no proprietary resulting trust in favour of the bank because the availability of resulting trust is restricted to two distinct categories; that there was no proprietary constructive trust because there was no impact on the conscience of the authority given that it had no knowledge of the invalidity of the contract at the time the money was paid to it; *Sinclair v. Brougham*[127] was probably not to be followed in future; and the controversial decision of Goulding J. in *Chase Manhattan Bank v. Israel-British Bank*[128] can be explained better although the result was probably correct.

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[119] [1994] 4 All E.R. 890, Hobhouse J., CA; [1996] A.C. 669, HL.
[120] [1994] 4 All E.R. 890, Hobhouse J.. The *Sandwell* action did not proceed beyond first instance.
[121] *Kleinwort Benson* v. *Birmingham City Council* [1996] 4 All E.R. 733, CA, on appeal from Gatehouse J., (unreported).
[122] *Kleinwort Benson* v. *South Tyneside M.B.C.* [1994] 4 All E.R. 972, Hobhouse J..
[123] [1991] 1 All E.R. 545, HL.
[124] [1995] 1 All E.R. 1, Hobhouse J..
[125] Lord Lloyd delivered a judgement which considered, as discussed above, the commercial context of equity rather than focusing, as Lord Browne-Wilkinson did, on the re-drawing of the commonly used equitable remedies and principles.
[126] Lord Slynn did not deliver a substantive judgement, although he did make some reference to awards of compound interest being available generally on where there has been fraud or some breach of fiduciary duty.
[127] [1914] A.C. 398.
[128] [1981] Ch. 105.

The context of local authority funding

Before embarking on the detail of the litigation, it is important to understand the context in which local authorities were seeking to enter into the interest rate swaps markets.[129] There were three factors which conspired at the one time. First, the local authorities in the UK had a statutory cap placed on the amount of money which they were able to raise through local taxation and also on the amounts which they were entitled to borrow. Therefore, the local authorities were seeking alternative means of raising finance or of manipulating existing financial arrangements. Given that interest rate swaps were, at the material times, off-balance sheet instruments, finance directors were able to use them without any requirement to declare them in annual accounts. This created a potential hidden source of extra funding.

Second, at a time of very high interest rates, the floating rate debt profiles of local authorities were unattractive. Given that local authorities were on fixed budgets, there was no advantage to paying rising amounts from that capped financial resource in interest payments. Therefore, the interest rate swap offered a tool with which local authorities could relieve the pressure on their restricted budgets by seeking fixed rate funding. This is the prudent, hedging motivation for the financial strategies of the local authorities. The type of interest rate swap at issue in *Islington* was a 'deep discount' interest rate swap which entitled the authority to a lump sum payable at the outset of the transaction which was repaid by re-calibrating the periodical swaps payments owed between them thus repaying the capital sum over time. This deep discount payment, in effect, raised extra debt funding outside the limits of the statutory rate cap. What is important about the swaps that were used by the local authorities is that they were 'deep discount' swaps which contained an element of loan, rather than straightforward vanilla interest rate swaps as the market would ordinarily understand them.

Third, at a time of volatile market movements, interest rate swaps enabled the local authorities to speculate on the markets. Any profit which could be made on financial markets would add to local authority budgets without requiring borrowing in breach of statute. Not all of the local authorities were involved in speculation. Unfortunately the London borough of Hammersmith and Fulham was very involved in speculation with the result that interest rate swaps were held to be beyond their powers under the *ultra vires* principle.[130]

The enthusiastic use of interest rate swaps by Hammersmith and Fulham led to the litigation which caused the House of Lords to rule that these products were ultra vires UK local authorities[131] and its speculative activities resulted in the authority owing ever more money under their debt portfolios than they had owed originally. There were a number of interest rate swaps outstanding between local authorities and the

[129] For accounts of the same passage of litigation see *Westdeutsche Landesbank Girozentrale v. Islington L.B.C.* [1994] 4 All E.R. 890, *per* Hobhouse J. For a brief account of the background to the litigation see McKendrick 'Local Authorities and Swaps: Undermining the Market?' in '*Making Commercial Law: Essays in Honour of Roy Goode*' ed. Cranston (Oxford, 1997), 201 *et seq*.
[130] [1991] 1 All E.R. 545, HL.
[131] *Hazell v. Hammersmith & Fulham* [1991] 1 All E.R. 545.

financial institutions before the litigation commenced in 1990 around Hammersmith and Fulham's entry into the marketplace. Lord Templeman found that there had been about 400 swaps entered into by 77 out of the 450 local authorities at that time. However, in relation to Hammersmith & Fulham,

> '[b]y 31 March 1989 the council had entered into 592 swap transactions and 297 of these were still outstanding. The total notional principal sum involved in all the transactions entered into by the council amounted in the aggregate to £6,052m … These figures distort the position because some swap transactions were a hedge against others. But there is no doubt that the volume of swap business entered into by the council was immense. The council's actual borrowing on that date amounted to £390m, its estimated expenditure for the year ending 31 March 1989 was £85.7m and its quoted budget for that year was £44.6m.'[132]

In the context of such a massive exposure compared to such a small level of borrowing and of expenditure, it would have been extremely surprising if the House of Lords had not decided the way it did. Otherwise, it would have fallen to the ratepayers of the borough to make good those amounts owed to the banks.[133]

Personal claims for restitution (money had and received)

Money had and received – personal claims in restitution

The leading case in this context is the decision of the House of Lords in *Westdeutsche Landesbank v. Islington.*[134] In that case, as considered below in detail,[135] the bank had made payments to the local authority under a ten year interest rate swap before the parties learned that the contract was void *ab initio*. The question was then whether the bank was entitled to recover moneys already transferred to the local authority under the contract under an action for money had and received: dubbed a "personal claim in restitution" by Lord Goff. In considering the appropriate principles affecting restitution at common law, the starting point for Lord Goff was with the speech of Lord Mansfield in *Moses v. Macferlan*[136], where he said that the "gist of the action for money had and received"[137] is that "the defendant, upon the circumstances of the case, is obliged by the ties of natural justice and equity to refund the money".[138]

It was held that there was therefore no reason of principle why a personal claim in restitution in favour of the bank should have been refused. In accordance with the prescriptions of the House of Lords in *Sinclair*, permitting such a claim would not have indirectly enforced the ultra vires contract "for such an action would be

[132] *Hazell v. Hammersmith & Fulham* [1991] 1 All E.R. 545, 552, *per* Lord Templeman.
[133] Always presuming that anyone remained living in the borough after the removal of services and exponential rise in local rates.
[134] [1996] A.C. 669.
[135] Cf. Hudson, *Swaps, restitution and trusts* (Sweet & Maxwell, 1999) generally.
[136] (1760) 2 Burr 1005, 1012.
[137] [1996] 2 All E.R. 961, 980.
[138] *Westdeutsche Landesbank v. Islington* [1996] A.C. 669; [1996] 2 All E.R. 961, 980.

unaffected by any of the contractual terms governing the borrowing,[139] and moreover would be subject (where appropriate) to any restitutionary defences …"[140] Further it achieved Lord Goff's underlying concern that the lender should not be without a remedy.

Similarly in *Guinness v. Kensington*[141] it was held that a contract which was *ultra vires* one of the parties was always devoid of any legal effect. Further, payments made under such a purported contracted were necessarily made for a consideration which had totally failed. Therefore, the money was recoverable under a personal claim in restitution (or, money had and received). A party to such a void swap was entitled to recover an amount equal to the difference between his payments and his receipts over the life of the purported swap. It would make no difference to the analysis that the swap had been completely performed. There could be no different right to property based on complete performance than had otherwise been the case.

Failure of consideration

The issue of absence of consideration arose in the decision of Lord Thurlow in *Heathcote v. Paignton*[142] in the context of the development of the law on absence of consideration:-

> '… if the inadequacy of the consideration is so gross that it shows that the plaintiff did not really understand the transaction, or was so oppressed that he was glad to make it, this will amount to fraud. But if that amounts to fraud, it is simply a roundabout way of saying that gross inadequacy of consideration justifies setting aside a contract.'[143]

These dicta highlight the problems of the courts of Chancery in considering commercial transactions. The first is that it is often only possible for the courts to interfere with freedom to contract where there has been some unconscionable behaviour which amounts to provable fraud. The other is the difficulty of intruding on freedom of contract by replacing the precise terms of the agreement with some standard arrived at by applying principles according to conscionability - for example, by judges fixing the price of the contract.

The tension which Hobhouse J. addresses is how it is that the logic of "absence of consideration" should apply to a situation where one of the Sandwell swaps had been completely performed before the commencement of proceedings. However, there is little analysis of the situation where there have been payments made under the other swaps in both *Westdeutsche Landesbank v. Islington* and *Kleinwort Benson v. Sandwell*[144] where those transactions were potentially to be considered as a series of forwards constructed as mutual debts. In considering the two actions before him, Hobhouse J. focused on the third and fourth swaps under which Sandwell had made

[139] Again it is important to note that the language of debt is being used.
[140] [1996] 2 All E.R. 961, 972-3.
[141] *Guinness Mahon & Co. Ltd v. Kensington & Chelsea RLBC*, CA, *The Times*, 2nd March 1998.
[142] (1787) 2 Bro. C. C. 167, 29 E.R. 96.
[143] *'The Rise and Fall of Freedom of Contract'*, Atiyah, (Oxford 1979), 174.
[144] [1994] 4 All E.R. 890.

no payments at all (because the netting arrangements meant that they owed no surplus amount to the bank). In that situation, his lordship held that there was an absence of consideration. However, with reference to the *Islington* swap and the second *Sandwell* swap, there was partial performance; with complete performance of the first *Sandwell* swap. As his lordship puts it: '… neither party can, on the contractual approach, say that there was any failure of consideration, let alone any total failure'[145] on the basis that the first *Sandwell* swap had been executed.

Therefore, Hobhouse J. moved on to consider the position in connection with an ultra vires contract where there is an absence of consideration, given the inapplicability of the *Fibrosa Spolka Akcyjna v. Fairburn Lawson Combe Barbour Ltd*[146] test of total failure of consideration. He held that:-

> '… in the absence of some special factor money paid under an ultra vires contract can be recovered as money had and received in the same manner as can money paid for a consideration that has totally failed.'[147]

Rescission in the local authority swaps cases

The form of restitution which Lord Goff favoured in his speech in *Westdeutsche Landesbank v. Islington* was one which returned the parties to the positions which they had occupied originally.[148] This rescission approach would appear to achieve two goals. On general restitutionary grounds, it has a superficial attraction in that it terminates the unjust enrichment which the local authorities enjoyed at the expense of the banks. However, as considered below, it would not necessarily restore to the banks the whole of the loss which they have suffered by entering into the transaction, including the cost of hedging arrangements.[149] The second goal achieved by the rescission approach is the avoidance of seeming to enforce the void contract by an award of lost opportunity cost to the parties. In the case of cash-settled derivatives, any award of damages[150] would be equivalent to performance of the contract.

The central issue is the ability of common law or equitable remedies to restore the parties to the positions which they occupied before they purported to enter into the deep discount swap transaction in *Westdeutsche Landesbank v. Islington*.[151] Given the nature of the property, all that would be required is a reverse payment of an equal amount of the same currency. As Lord Goff considered the position, ' … in the present case, there ought to be no difficulty about that at all … because the case is concerned solely with money.' [152] The restitution-by-rescission approach simply requires that

[145] [1994] 4 All E.R. 890, 925, Hobhouse J.
[146] [1943] AC 32, 48.
[147] [1994] 4 All E.R. 890, 926, Hobhouse J.
[148] [1996] 2 All E.R. 961, 966.
[149] See on this the discussion of the defence of passing on in *Kleinwort Benson v. Birmingham C.C.* below.
[150] Providing they are payable in the contract currency.
[151] [1996] A.C. 669.
[152] [1996] 2 All E.R. 961, 966.

> ' … 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 … with an appropriate order for the payment of interest.'[153]

The most suitable method of achieving the result would be to affect an equitable set-off in respect of the moneys which remained outstanding.[154]

Trusts implied by law

When proprietary claims will be available

The principal form of proprietary claim in relation to unenforceable derivatives contracts will be a constructive or resulting trust, as demonstrated by the local authority swaps cases. The clearest judicial statement of the nature of the trust was that of Lord Browne-Wilkinson in *Westdeutsche Landesbank v. Islington.*[155] That case, as considered in detail below,[156] concerned an interest rate swap in which moneys were transferred outright by a bank to a local authority as payments under that swap before the parties learned that the swap contract was outwith the capacity of the local authority and was therefore void *ab initio*. The bank argued that the local authority should be deemed to hold those moneys on trust for it as a result of the injustice of allowing the local authority to retain the money on the basis either of the parties' mutual mistake or the failure of their contract. They sought to argue such a trust so that they could receive compound interest on their money rather than merely simply interest. Their argument failed in front of the House of Lords for the following reasons.

In the leading speech of Lord Browne-Wilkinson in *Westdeutsche Landesbank v. Islington*[157] the kernel of the trust concept was identified as being equity operating on the conscience of the person who is the owner of the legal title in property. There was then a distinction made between an "express or implied trust" on the one hand or a trust imposed 'by reason of his unconscionable conduct' which is termed a "constructive trust".[158] Given the importance of conscience in the equitable jurisdiction, it is further said a person 'cannot be a trustee of the property if and so long as he is ignorant of the facts alleged to affect his conscience'.[159] It is on this basis that the local authority in the *Islington* appeal could not be held to have been a trustee of the moneys it received from the bank because it did not know it lacked the legal capacity to enter into the interest rate swap contract until after the House of Lords decision in *Hazell v. Hammersmith & Fulham*[160] declaring that incapacity which came some years after it had received and spent the money. To succeed in a claim that there be a constructive trust imposed, it must be shown that the defendant had some

153 [1996] 2 All E.R. 961, 966.
154 On equitable set-off see in relation to collateral.
155 [1996] A.C. 669.
156
157 [1996] A.C. 669.
158 [1996] A.C. 669, [1996] 2 All E.R. 961, 988.
159 [1996] A.C. 669, [1996] 2 All E.R. 961, 988.
160 [1991] 1 A.C. 1.

knowledge of 'the factors which are alleged to affect his conscience' at the time he received the money or at some time before he disposed of it.[161]

The further problem which arose on the *Islington* appeal was that the property which had been transferred under the deep discount payment had ceased to be identifiable when it was transferred into a bank account which had subsequently gone overdrawn. This was said to offend against the principle that there must be identifiable trust property before there can be a valid trust: the overdraft on the account proved that the property which had been in that account had ceased to be there and that money was, as a matter of fact, impossible to trace after it had left that account.[162] As Lord Browne-Wilkinson held, in reliance on *Re Goldcorp Exchange Ltd (in receivership)*[163] '[o]nce there ceased to be an identifiable trust fund, the local authority could not become a trustee' of the money it had received from the bank.

On the facts before him, Lord Browne-Wilkinson held that there was never a coming together of all of these factors before the judgement in *Hazell v. Hammersmith & Fulham L.B.C.* was handed down. As his lordship held:-

> 'There was therefore never a time at which both (a) there was defined trust property and (b) the conscience of the local authority in relation to such defined trust property was affected. The basic requirements of a trust were never satisfied.'[164]

As such, equity will not grant any proprietary remedy to the payer under a void contract unless there had been either some effective, express retention of proprietary rights or some unconscionable act on the part of the recipient which would create a constructive trust.

When proprietary claims will be available under a void contract

The capacity of the counterparty and the enforceability of the subject matter of the agreement are necessary preliminary issues in contracting financial derivatives, given the number of contexts in which their efficacy has yet to be tested by the courts and also given the endless innovation of the markets. Therefore, a void contract creates issues beyond the express termination provisions of the contract itself to do with restitution and the enforceability of property rights in money or other assets transferred as part of the agreement. The principles of restitution and implied trusts address these commercial concerns in the event of the failure of the contract.

The central question addressed by the House of Lords in *Westdeutsche Landesbank v. Islington* was:

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[161] [1996] A.C. 669, [1996] 2 All E.R. 961, 988.
[162] [1996] A.C. 669, [1996] 2 All E.R. 961, 988. There is an exception to this principle in the case of personal liability imposed under constructive trust on a person who dishonestly assisted in a breach of trust.
[163] [1995] 1 A.C. 74.
[164] [1996] A.C. 669, [1996] 2 All E.R. 961, 988-989.

> "Does the recipient of money under a contract subsequently found to be void for mistake or as being *ultra vires* hold the moneys received on trust even where he had no knowledge at any relevant time that the contract was void?"[165]

There are two issues arising from this understanding of the question. First, whether an unjust factor will cause the imposition of a trust. Second, the establishment of 'knowledge' as the appropriate yardstick by which the applicability of the trust would be appropriate. The restatement of the core rules of equity in the speech of Lord Browne-Wilkinson in *Westdeutsche Landesbank v. Islington*[166] created a test that a proprietary claim in equity 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 - which will generally not be the case in respect of transactions entered into in good faith by both parties.

Given that there was no viable express contract between the parties, despite what has been said elsewhere about the possible operation of the doctrine of severance,[167] the House of Lords in *Islington*[168] was unanimous in holding that neither the deep discount payment made by the bank nor any of the interest amounts were to be held on resulting or constructive trust and thus liable to attract compound interest. 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.

Availability of compound interest

The availability of compound interest in relation to financial derivatives claim was found in *Westdeutsche Landesbank v. Islington* to represent the rate of return expected by market participants on their money if they were to enter into straightforward lending transactions with it. An award merely of simple interest would be less than the return which the seller would have expected.[169] The award of compound interest is an equitable remedy however which was at the only issue strictly at issue before the House of Lords in *Islington*,[170] despite that tribunal deciding it was necessary to consider broader questions. Therefore, in spite of the commercial expectation that compound interest would be available, its award by the courts its only available where the plaintiff can demonstrate a pre-existing equitable proprietary interest in the property in relation to which compound interest is sought. The main shortcoming of equity is that it will not be imposed in many situations in which there has not been evident fraud. As Lord Browne-Wilkinson explained:

165 [1996] 2 All E.R. 961, 986.
166 [1996] A.C. 669, [1996] 2 All E.R. 961.
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168 [1996] A.C. 669, [1996] 2 All E.R. 961.
169 Rightly, the courts did not attempt an exercise in second-guessing the forms of investment which might have been undertaken other than the vanilla option of a rate of return based on ordinary lending.
170 [1996] A.C. 669; [1996] 2 All E.R. 961.

> "In the absence of fraud the courts of equity have never awarded compound interest except against a trustee or other person owing fiduciary duties who is accountable for profits made from his position."[171]

In his lordship's opinion the authorities established that in cases where there was no demonstrable fraud, compound interest would only be awarded against a defendant who is "a trustee or otherwise in a fiduciary position". [172] The appropriate response for a court in such a situation would be "recouping … an improper profit made by him": that is, making restitution of that profit.[173] Two points would appear to arise. First, it is possible to identify the restriction, considered above, of equitable remedies such as the provision of compound interest to fairly uncontroversial categories of fraud or breach of fiduciary duty. Second, the response advocated by his lordship is one of recouping a profit made outwith such a duty - a response which smacks of restitutionary purpose[174] as much as equitable operation on the conscience of the defendant.

Lord Goff was prepared to allow an order for the payment of compound interest. The starting point for Lord Goff, as considered above, was with the speech of Lord Mansfield in *Moses v. Macferlan*[175], where he said that the 'gist of the action for money had and received'[176] is that "the defendant, upon the circumstances of the case, is obliged by the ties of natural justice and equity to refund the money". Thus, in considering whether or not compound interest ought to have been awarded to the bank, Lord Goff felt that it would have been 'strange indeed if the courts lacked jurisdiction in such a case to ensure that justice could be fully achieved by means of an award of compound interest'.[177]

Collateralisation and credit support now?

There are a number of contexts in which the standard market documentation is deficient in its coverage of issues related to taking proprietary rights,[178] retention of title, and segregation of assets to be delivered in particular. Rather than a criticism of the ISDA and other market formats, this discussion is meant as a recognition of the fact that standard market documentation will not be able to deal with all of the many contexts in which this issue could potentially arise. The message for the lawyer is the need to adapt standard market documentation to cope with the particular context. The following discussion therefore continues the discussion of termination which was commenced above by analysing the commercial context and law surrounding the issue of termination and recovery of property in relation to financial derivatives.

One weakness of the ISDA architecture in this context is that all of the transactions executed between two parties are deemed to constitute one single contract. Therefore,

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171 [1996] A.C. 669; [1996] 2 All E.R. 961, 984.
172 [1996] A.C. 669; [1996] 2 All E.R. 961, 985.
173 [1996] A.C. 669; [1996] 2 All E.R. 961, 985.
174 Birks, *Introduction to the Law of Restitution*, 11.
175 (1760) 2 Burr. 1005, 1012.
176 [1996] 2 All E.R. 961, 980.
177 [1996] 2 All E.R. 961, 980.
178 See, for example, the discussion with reference to collateral.

the entire web of contracts entered into between two parties – master agreement, schedule, confirmations, and credit support documents – will be ignored in litigation if the contract is found to be beyond the powers of one or other of the parties.[179]

Similarly, the current vogue for collateral agreements which provide that the party posting collateral will pledge absolute title in that property to the other party means that the party posting collateral has no rights in any property which it can recover in the event that the contract is held to have been void. What it does achieve, however, for the party receiving collateral is the reassurance that all property posted with it has become its property absolutely and therefore will defeat any future claim for recovery of that property, always assuming that it was not acquired by force or fraud.[180]

A preferable arrangement would be to have a free-standing trust structure such that either party is entitled to be vested with full equitable title in any collateral posted in that structure. The trust structure would mean that the beneficiary under such a trust would be entitled to be treated as a secured creditor in any insolvency.[181] In this way either the party posting collateral or the party receiving collateral would be able to recover property held on trust. This is particularly so where both parties are required to post collateral with each other and therefore both parties bear the risk of the other's failure to perform. A free-standing trust structure would be a structure which is not provided as being linked into a single agreement with the master agreement, confirmation and so forth and therefore could continue to exist even if the contract were found to be unenforceable.

4.2 Performance of financial derivatives agreements

Frustration

Market disruption and extraordinary events

The question is then whether or not there will have been frustration so that the contract can be taken to have been avoided. The test is whether or not the contract is rendered "as a matter of business a totally different thing",[182] or whether or not matters have become impossible so that the subject matter of the contract has become "for business purposes something else",[183] so that it is something other than that for which the parties can have been intended to have contracted.[184] Such an analysis may be made easier by the inclusion of some maximum volatility clause or similar provision, as considered in the next section,[185] which would specify the purpose of the transaction, or the point in time at which the parties would consider its purpose to have been frustrated. In the absence of such a contractual provision it will be a matter of degree

[179] E.g. *Westdeutsche Landesbank v. Islington* [1996] A.C. 669.
[180] As considered below.
[181] *Goldcorp, re* [1995] 1 A.C. 74.
[182] *Bank Line Ltd v. Arthur Capel & Co.* [1919] A.C. 435, 460.
[183] *Asfar & Co. v. Blundell* [1896] 1 Q.B. 123, 128.
[184] *Ibid*, where a shipment of dates were waterlogged such that there were no longer of suitable quality; *The Badgary* [1985] 1 Lloyd's Rep. 395. Cf. *Horn v. Minister of Food* [1948] 2 All E.R. 1036.
[185]

whether or not the performance of the contract is to be considered to be too onerous in the circumstance.[186]

Matters may not be as straightforward as the contract becoming absolutely impossible to perform. The guiding principle remains whether or not the contract is rendered "as a matter of business a totally different thing".[187] For example, there might be a question as to the effect of the change in the trading on the index resulting from the failure of a significant part of the index. Arguably, the position of the parties would be that the true intention of the contract, to create a synthetic security payments under which mirror the normal movements of that index, had been frustrated by the index itself being all but destroyed by the violent, and unexpected movements of one of the components within it. Clearly there will be a question of degree. If the index is completely removed at the instigation of the sponsor which calculates the level of the index, then the index itself will no longer exist. The consequences for the transaction must be the same as if it were a contract for the transportation of a commodity which is destroyed before the creation of the contract: that is, underlying purpose of the contract has been frustrated.

It is a question of fact whether or not the contract is frustrated by the violent movement of one of the components of the index. If the movement is so great as to alter the subject matter of the contract so much that what remains is manifestly contrary to that which was intended by the parties at the time of their contracting, then there must be frustration once again. The question might then be, in any event, whether or not the parties could be said to have received part of that which they contracted for if a certain number of payments have been made under the agreement. If a series of payments have been made and the index does not collapse until the derivative instrument has been in operation for some time, the legal analysis of the instrument will be all important.

The party alleging frustration (presumably on the basis that the instrument is out of the money and therefore wishes a remedy which will terminate the agreement) would argue that each separate payment constitutes a separate option or forward contract. Alternatively, the party for whom the index is in the money will argue that the index should continue as is or that it can be amended such that the instrument can continue in existence. This latter argument must be based on the assertion that the derivative constituted one entire transaction with payments to be made on separate dates, which has been performed in part and which cannot then be subjected to any equitable form of termination. The answer to these vexed questions will clearly turn on the interpretation of the product in question. If the confirmation and the description of the production by the parties in that confirmation constituted a series of options to receive money or to perform some act, then there must be a separate instrument in respect of each of those events.

These issues will require an analysis of the particular facts to be resolved in any particular case. The minimisation of market exchange risk will therefore be alleviated by the correct structuring of the relevant product.

[186] Cf. *Multiservice Bookbinding v. Marden* [1979] Ch. 84 where is was held that such a shift will be immaterial if agreed by commercial parties who were properly advised.
[187] *Bank Line Ltd v. Arthur Capel & Co.* [1919] A.C. 435, 460.

Maximum volatility provisions

Some exchanges have a maximum price volatility beyond the confines of which trading on the security or commodity is suspended. The question will be then whether any of such movements outwith that bracket of anticipated volatility would be material market disruptions for the purposes of the particular derivatives contract at issue. It would also be a question for the parties as to whether or not they sought to identify from the outset the perameters within which they expected the underlying market to move. For example, an unexpected revolutionary coup or an unexpected economic crisis in one jurisdiction which would lead to a collapse in that country's currency and its stock market such that any index priced according to movements on that market would be outwith the parties' expectations (unless they had priced that into the transaction). In one decided case a moratorium in the Russian banking market prevented payments being made under a hedging transaction.[188] To avoid such unexpected shocks, the unexpectedly large impact on the level of payment to be made and the unexpectedly large payment obligations they may bring, the parties would be well-advised to include in their documentation some provision as to the maximum amount of volatility which they expected from the indices. On this basis they could cap either party's duty to pay or right to be paid and so protect themselves against unanticipated movements in the underlying market.

The effects of leaving such contingencies unmet arose in a case in the early 1970's in which a mortgagor agreed to pay a rate of interest to a mortgagee which was index-linked to the price of sterling against the Swiss franc.[189] Subsequently, sterling was devalued in 1971 with the result that the interest rate payable was extremely high. The mortgagor argued that the contract should have been set aside on the basis that this index-linking provision constituted an unfair collateral advantage to the mortgagee and a fetter on the right of redemption under the mortgage contract. The court held that because the parties had been independently advised as to the terms of the contract they were to be held to its terms, regardless of the fact that the payment amounts were larger than had been anticipated. This case illustrates the need to express the level of price movement which is expected in any situation.

In any event it is suggested that it is important that market participants include some statement of the purpose of their transaction in their documentation so that they acquire insulation against unexpected market disruption or other events. At the time of contracting such provisions typically seem unnecessary because, by definition, no-one expects the unexpected to take place. However, that is precisely the role of the lawyer, to protect the client against the risk of future events whether seen or unseen at the time of creating the contract.

SEVERANCE

Severance has the effect of ensuring the validity of those parts of the contract which are maintained. The classic statement of the doctrine of severance is that:

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[188] *Australia and New Zealand Banking Group v. Societe Generale* [2000] 1 All E.R. (Comm) 682 (CA), [2000] C.L.C. 833, [2000] Lloyd's Rep. Bank. 304.
[189] *Multiservice Bookbinding v. Marden* [1979] Ch. 84.

> "… 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."[190]

The decision of Megarry J. in *Spector v. Ageda* [191] 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.

4.3 Validity of derivatives contracts

Capacity and authority issues

Authority

The question of authority is to do with the authority of the signatory to enter into the contract on behalf of the company.[192] Under normal principles of agency law, an agent (a signatory on a document for example) cannot have a greater capacity to act than the company itself. This principle has been somewhat complicated by the Companies Act 1989, which altered the way in which the *ultra vires* rule works by protecting third parties dealing with an English company in good faith from having their contract avoided by the company on the basis that the contract was outwith its powers.[193] In some circumstances it will be possible for a third party to argue that the agent had ostensible authority to act even where that agent was in fact acting outwith its powers.

The representation which is usually sought is that the signatory, as listed on any signatory register authorised by the board of directors within the terms of the company's memorandum and articles of association, does have the authority to do what that signatory is purporting to do. Furthermore, it is usual to seek some evidence that the necessary formalities within the company have been performed and that any necessary consents have been obtained.[194]

Capacity

The capacity issue relates to the ability of the company itself to enter into derivatives transactions on the basis of its constitutive documents, as opposed to the power of any agent to sign on behalf of the company.[195] The representation made is therefore that the

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[190] *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.
[191] [1973] Ch. 30.
[192] *ISDA Multicurrency Master Agreement* (ISDA, 1992), section 3(a).
[193] See the discussion of this issue in para 6-14.
[194] In the wake of issues like the Barings crash and the Proctor and Gamble failure the issue of internal control and consents can be expected to become ever more important.
[195] ISDA Master Agreement at section 3(a).

entity does have the ability to do what it is purporting to do under the master agreement. The fact that a representation is made raises the question of the ability of the party to sue the counterparty making the representation for a breach of that representation. Briefly put, if the company does not have the power to sign a contract it cannot purport to render binding any representation which is included in that contract. It would clearly be possible to assert that that representation was a material inducement on the part of the parties to entering into the contract, on the basis that they would not have done so without such assurance. The request for legal opinions and evidence of authority, which are discussed below, raise this representation from the status of being simply a clause in a standard agreement to something upon which the parties were relying in the formation of this contract.[196] However, that does not in itself grant the maker of the representation a power to bind the counterparty although it may found a claim against the maker of the representation personally or exceptionally the transaction may be saved by statute, such as the Companies Act 1989.[197]

Under a derivatives transaction which is declared void because it is beyond the powers of one of the parties, a claimant will seek some restitutionary remedy for a breach of such a representation. The argument would run that the person making the representation has been enriched as a result of some unjust factor, to whit the claimant's reliance on a representation which it relied upon in entering into the transaction. This argument was advanced in *Westdeutsche Landesbank Girozentrale v. London Borough of Islington*,[198] which is considered below.[199] That case provides some authority for the point that there are be personal restitutionary remedies available at common law in a situation where lack of capacity is the issue preventing enforceability of the derivatives transactions. That is, the recipient of money under a void transaction is required to repay money received under that transaction as money had and received at common law.[200] However, there would be no proprietary claim and consequently no compound interest on repayment of that money where the traceable proceeds of the moneys paid under the transaction were not identifiable.

It was found expressly that no term in the contract could be efficacious if the contract itself had been held to be void.[201] As Leggatt LJ put it:

> "The parties believed that they were making an interest rate swap contract. They were not, because such a contract was *ultra vires* the local authority. So that they made no contract at all."[202]

Therefore, the termination provisions based on the representation, the credit support language and all of the other provisions would be ineffective because the entire contract was beyond the powers of the defendant. This appeal demonstrates that there can be no specific efficacy of a representation that the contracting party has the capacity to contract. Therefore, there will be no liability for damages arising from the breach of

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198 [1996] A.C. 669.

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200 *Ibid*.

201 *Westdeutsche Landesbank v. Islington* [1994] 4 All E.R. 890, 967, *per* Leggatt LJ. See also Hudson, "Proprietary rights in financial transactions" (1997: 2) *Amicus Curiae*, 27.

202 *Ibid*.

warranty. The approach of the master agreement must therefore be to initiate automatic termination of the contract in the event that any of these representations fail.

Gaming contracts

It is a commonplace of most systems of contract law that, for reasons primarily of public policy, gaming, betting and wagering contracts will be null and void.[203] No amount allegedly won on a gaming or wagering contract is recoverable at law or in equity.[204] With the development of each new derivatives product and with the export of established derivatives products to new jurisdictions the question always arises whether or not those contracts are to be defined as being gaming or wagering contracts such that they would not be legally enforceable. To make matters more complex, the definition of a gaming or a wagering contract under English law is a matter dealt with by the caselaw and not by statute. The reason why derivatives are frequently considered to be capable of definition as gaming or wagering contracts, in theory at least, is that the amount payable under a cash-settled derivative involves taking a bet on the outcome of some underlying price or index; or, to adopt a definition from the caselaw a derivatives contract will frequently be a situation in which

> "… two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other … a sum of money".[205]

Where there is physical settlement it is less likely that the transaction will be assumed to be a gaming or wagering contract because it will be assumed that the receiving party had a genuine intention to take title in those physically delivered assets.

Under the Financial Services and Markets Act 2000, contracts falling within s.412 of that Act are not "void or unenforceable because of s.18 of the Gaming Act 1845" and so on.[206] The definition of contracts which are covered by the 2000 Act are defined in the following terms:[207]

> 'This section applies to a contract if –
> (a) it is entered into by either or each party by way of business;
> (b) the entering into or performance of it by either party constitutes an activity of a specified kind or one which falls within a specified class of activity; and
> (c) it related to an investment of a specified kind or one which falls within a specified class of investment.'

203 Gaming Act 1845, s.18: "All contracts or agreements, whether by parole or in writing, by way of gaming or wagering, shall be null and void … no sum shall be brought or maintained in any court of law and equity for recovering any sum of money or valuable thing alleged to be won upon a wager …". See generally Treitel, "Gaming and Wagering", *Chitty on Contracts*, ed. Guest et al, (London: Sweet & Maxwell, 28th edition), chapter 38.

204 *Ibid*. Similarly agents are not entitled to recover sums from principals under such arrangements: Gaming Act 1892, s.1, reversing, *inter alia*, *Read v Anderson* (1884) 13 Q.B.D. 509.

205 *Carlill v. The Carbolic Smoke Ball Company* [1892] 2 Q.B. 484, 490, *per* Hawkins J.

206 Financial Services and Markets Act 2000, s.412(1).

207 Financial Services and Markets Act 2000, s.412(2).

4.3 LITIGATION CASE STUDY – *BANKERS TRUST V. DHARMALA*

In the context of derivatives there has been one reported decision which has considered the specific liability of the sellers of financial derivatives in the decision of Mance J. in the case of *Dharmala*.[208] This case summarises precisely the issues which are specific to the selling of financial derivatives in general and interest rate swaps in particular.[209] It is therefore proposed to consider the range of claims and factual issues which arose in that litigation before referring them to the specific discussions of each form of contractual, tortious, equitable and restitutionary liability considered below.

Bankers Trust (BT) sold two forms of interest rate swap to Dharmala (DSS) on which DSS lost money. The litigation centres on BT's attempts to recover money owed to it under the transactions and DSS's concomitant attempts to deny any liability for amounts owed under the transactions. DSS argued most of the range of tortious and contractual claims considered in this *Suitability* section: the concept of the unsuitability of the products sold appears in their basic contentions. DSS contended that BT were liable for negligent misrepresentation, deceit in the course of selling the products, and breach of contract.

DSS were an Indonesian entity with whom BT had had dealings before. On the facts ultimately Mance J. found that the employees of DSS involved in the transaction had received sufficient attention and advice from BT. Furthermore, however, it was found that in DSS, BT had a counterparty who could be expected to have some experience of the financial derivatives markets, being a financial institution, despite the complexity of the products which BT were designing. Importantly, it could be anticipated that DSS would be able to undertake their own evaluation of the products which were suggested to them by BT. However, Mance J. highlights the need to consider the specific relationship between buyer and seller before reaching a decision on the precise nature and extent of the obligations owed.

The derivatives products at issue

Swap 1 was contracted in January 1994 for a nominal amount of US$50 million and with a period to expiry of two years. The main economic terms of the agreement were that DSS would pay interest annually at LIBOR and that BT would pay interest annually, reciprocally at LIBOR+1.25%. Further, DSS was required to pay interest annually at 5%, whereas BT owed a reciprocal obligation to pay interest annually at 5% multiplied by a factor of N/183. The factor N/183 represented the number of days within a given reference period for which LIBOR was below 4.125%. Therefore, DSS bore the risk that LIBOR would exceed 4.125%, thus giving it no right to receive any interest payment. The parties executed a master agreement in the standard ISDA form in early 1994 but DSS

[208] *Bankers Trust International PLC v. PT Dharmala Sakti Sejahtera* [1996] CLC 518; see also Picarda, "Interest Rate Swap Agreements in the Courts" [1996] BJIBFL 170.

[209] For a particularly useful summary of the decision, see the Financial Law Panel's "*Bankers Trust v. PT Dharmala Sakti Sejahtera*: Case Summary" (London, Financial Law Panel, January 1996).

did not sign any of the agreements related to provisions of the Financial Services Act 1986 and SFA regulations which BT asked it to sign.

Significantly, due to movements in the US Federal Funds rate on 4th February 1994, LIBOR rose. The parties replaced Swap 1, by mutual agreement as to its cancellation, with Swap 2 at that point.

Swap 2 was a form of barrier swap which provided that certain payments under the transaction would not fall to be made unless LIBOR crossed through an identified barrier level. The nominal amount was a total of US$50 million divided into two tranches of US$25 million each. Further, BT agreed to make a discount payment of the first year's interest subsidy in advance. BT was contracted to pay LIBOR+1.25%, in return for which DSS would pay LIBOR-2.25% "plus a spread". The spread effected the barrier by requiring that no spread was payable until LIBOR went above 5.25% in the first reference period, and 5.3125% in the second reference period.[210] The spread produced a multiple by which the amount payable by DSS was to increase. The impact of the spread was a total liability of US$17 million where LIBOR reached 6%, as opposed to a maximum liability under Swap 1 of US$3.75 million if LIBOR moved above 3.75% rate. The initial attraction of Swap 2 is the increased differential between the LIBOR amount received and owed by DSS.

LIBOR rose as a result of further upward shifts in the US Federal Funds rate on 22nd March 1994. This led to a re-negotiation of the barrier thresholds to account for the movement in LIBOR. DSS commenced proceedings in Indonesia to rescind the swap agreements. The Indonesian action led to judgement for DSS. BT commenced proceedings in the English Commercial Court for payment of sums equal to US$65 million which it claimed was DSS's total liability to it under the swap agreements.

In response to BT's action for money owed, DSS counter-claimed a long series of common law actions which revolve around the common theme of the suitability of the products sold and the manner in which they were sold and manufactured.[211]

Undue influence

As considered with reference to the *Dharmala* case above,[212] the issue of undue influence may also turn on the relationship between the buyer and the seller. In circumstances where the buyer would typically rely on the seller for advice without recourse to any other expert, perhaps as its house bank which provided all its finance requirements, and where the client has no particular financial expertise of its own, the seller must be particularly careful in marketing complex products. In *Dharmala* itself, DSS argued that BT owed it a duty to suggest more straightforward products which would have achieved its objectives. Mance J. found that DSS had been involved in

[210] The reference periods corresponded to the two tranches of notional amount under Swap 2.
[211] As a matter of Indonesian law, DSS also claimed that it did not have the capacity to enter into these transactions. It is not proposed to consider this point of Indonesian law in the following discussion.
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and eager for the particular product created. However, where a more risky and complex product is foisted on the buyer by the seller, in circumstances where vanilla, less risky products would have achieved the same goals, it is suggested that the seller is at risk of a claim for undue influence brought by the buyer.

A claim for undue influence, if successful, permits the victim to set aside the transaction which has been created as a result of that undue influence.[213] This action is categorised as a form of "constructive fraud".[214] The victim will be able to set aside a transaction on the basis that there has been some form of undue influence but not as a means of protecting itself from the result of its own folly or failure to act.[215] Furthermore, the victim will not be able to establish undue influence simply because there is inequality of bargaining power between transacting parties; rather, the buyer must show some undue influence over and above that.[216]

The issue is this: if equity will respond to a fiduciary who takes unacceptable levels of risk with the trust fund, what is it that will lead to a person being made a fiduciary? IN a fiduciary relationship[217] although, it is suggested, there are circumstances in which the advising seller so inter-meddles with the affairs and risk management objectives of the buyer that the seller must come to occupy a fiduciary relationship in respect of its counterparty and client.[218]

The role of the equitable doctrines of undue influence, constructive trusts to give effect to the settlor's intentions and of common intention constructive trusts, were not issues raised by Lord Browne-Wilkinson in *Islington*.[219] In *Barclays Bank v. O'Brien*[220] the House of Lords established the need to take independent advice. The issue arises then: what advice will dispel the undue influence? Further to *Credit Lyonnais v. Burch*,[221] it is not clear whether there is the possibility of undue influence in OTC derivatives market or whether these multinational organisations are simply arm's length parties. The decision in *O'Brien*[222] as to the application of the principle of undue influence in the provision of guarantees in respect of domestic mortgages, could be extended to cases of commercial guarantees or collateral agreements which are obtained in respect of derivatives transactions. It is possible to argue that

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213 *Allcard v. Skinner* (1887) 36 ChD 145; *National Westminster Bank v. Morgan* [1985] AC 686; *Barclays Bank v. O'Brien* [1994] 1 AC 180; *TSB Bank v. Camfield* [1995] 1 All ER 951.
214 See *Snell's Equity*, 29th edn. (Sweet & Maxwell, 1990), 550.
215 *Tufton v. Sperni* [1952] 2 TLR 516.
216 *National Westminster Bank v. Morgan* [1985] AC 686; although it is perhaps unclear how this doctrine is to be applied in the wake of *O'Brien*.
217 *National Westminster Bank v. Morgan* [1985] AC 686.
218 *Lloyds Bank v, Bundy* [1975] QB 326, a decision which concerned advice given by a bank to an old man who relied entirely on the advice of the bank's manager: cf: *National Westminster Bank v. Morgan* [1985] AC 686..
219 [1996] AC 669.
220 [1994] 1994] 1 AC 180, [1993] 3 WLR 786.
221 [1997] 1 All ER 144. See also *Barclays Bank v. O'Brien* [1994] 1 AC 180; *CIBC Mortgages v. Pitt* [1994] 1 AC 200; *Massey v. Midland Bank* [1995] 1 All E.R. 929; *Midland Bank v. Serter* [1995] 1 All E.R. 929; *Bank of Boroda v. Reyerel* [1995] 2 F.L.R. 376; *Banco Exterior Internacional v. Mann* [1995] 1 All ER 936; *Halifax Mortgage Services Ltd. v. Stepsky* [1996] Ch. 1; [1995] 4 All ER 656; *Banco Exterior International SA v. Thomas* [1997] 1 WLR 221; [1997] 1 All ER 46; *Barclays Bank v. Thomson* [1997] 4 All E.R. 816.
222 [1994] 1994] 1 AC 180, [1993] 3 WLR 786.

O'Brien[223] is a decision which is also about risk allocation. In compiling a test for equity in commercial situations, a test of 'commercially acceptable conduct' may be better than 'unconscionable conduct'. As with *Tan*,[224] there would be an establishment of an objective standard of probity.

Misrepresentation

The claims based on consent, as that term is defined for the purposes of this discussion, were as follows. First, that BT misrepresented the terms of Swap 1. DSS claimed in particular that it had been led to believe that the products had a low likelihood of generating a loss for DSS. DSS also contended misrepresentation on the basis that it understood that complete and accurate economic information had been supplied by BT which induced DSS to enter into the transactions. DSS also relied on alleged representations that BT would replace the transactions at no cost if there were some loss to DSS. The same arguments related to Swap 2 with the addition of an argument that BT had represented that Swap 2 would be better for DSS than Swap 1.

Second, DSS argued that there had been deceit on the part of a specific employee of BT. This highlights the importance of the "rogue trader" in making representations to a client, particularly where they are motivated by a desire to increase a particular trading desk's profit and thus lead to fraudulent inducements to deal. On these facts DSS alleged that BT had represented that there could only be profit under the transactions, whereas correspondence and marketing material made little or no mention of the risks involved.

Third, it was contended that BT's alleged representation that the transactions would be replaced at no cost constituted a collateral contract, if not a term of the contract itself. The claim on behalf of the buyer is this supported by allegations relating to conversations and communications passed between its agents and the seller's agents. In circumstances where there is little or not documentation[225] it becomes more difficult for the seller to establish the full extent of the obligations which were agreed between the parties. Reliance solely on tape recorded evidence of conversations and the buyer's understanding of those issues which must have formed part of its necessary understanding of the effectiveness of the contract, make it difficult for the seller to demonstrate that its liability was to be restricted to particular express contractual terms only.

Fourth, breach of duty culminating in negligence. DSS contended that BT were experienced dealers in the products at issue in a way that DSS were not. Consequently, DSS sought to fix BT with a duty in negligence to establish the level of competence which DSS had, to explain all risks to DSS, to consider the particular objectives of DSS, and to ensure DSS took independent advice. This list of alleged failings on the part of the seller raise a broad range of issues for the seller of derivatives. A duty of care on the seller to establish the level of

[223] [1994] 1994] 1 AC 180, [1993] 3 WLR 786.
[224] *Royal Brunei Airlines v. Tan* [1995] 2 AC 378, [1995] 3 WLR 64.
[225] An issue which did not arise in *Dharmala*.

competence which the buyer has moves beyond the Bank of England's regulatory requirements that the seller know their client. However, it is difficult to see how they move usefully beyond that. The buyer will always be entirely reliant on the seller in circumstances of inequality of bargaining power in a way that provision of modelling materials will generally not assist. Therefore, the purported obligation on the seller to explain all risks to DSS appears a more feasible requirement only if the seller is required to explain those risks to the buyer in the context of the buyer's knowledge and expertise. The attempt by BT in another piece of litigation, brought by Proctor and Gamble, to argue that it had discharged any obligation to advise as to the risks of a product by sending the pricing model to the counterparty would not satisfy this purported standard because it does not take into account the probability that an inexperienced client will make little sense of the risks involved by analysis of a complex mathematical model.

The further argument raised by DSS revolved then around a presumed positive obligation on the part of the seller to consider the particular objectives of DSS, and in particular whether or not there were other products or methods which DSS could have used to achieve the risk management requirements it had. In the context of a bank which is retained to provide all of the financial advice taken by a client, this test might be appealing. However, where an institution is asked to advise on a structure to achieve a particular objective there is a need for the buyer to expect that the seller will select a mechanism which will make it the most fee income while also achieving the buyer's objectives. It seems a little overly optimistic to expect and demand a level of altruism from sellers in circumstances where they are seeking to make fee income. The more important aspect of the test appears to be disclosure of adequate information and effectiveness of the product used. The final argument that BT ought to have ensured that DSS took independent advice strays close to undue influence without raising an argument that DSS has necessarily been unduly influenced in a way which ought to have required independent advice.[226] There is necessarily a conflict in asking a financial advisor to require a client to approach another financial advisor, in the context of the derivatives markets undoubtedly a competitor, to check the suitability of the product sold.

There are indications in the judgement that the relationship between the parties is of a particular nature that is needs to be considered on its own facts. By extension then, the circumstances of all sellers and buyers of financial derivatives need to be considered on their own facts. In particular Mance J. held that not all statements made by BT are necessarily to be considered to representations if DSS is to be expected to exercise its own skill and judgement as to that statement. To this extent the Bank of England's London Code is cited with approval in its approach to each individual client and an evaluation of that client's level of knowledge and expertise in the requisite field.

First, Mance J. held that in respect of the claim for misrepresentation most of DSS's contentions were simply not supported by the facts. In particular DSS

[226] Similar perhaps to the obligations set out in *Barclays Bank v. O'Brien* [1994] 1 AC 180, although that obligation to ensure taking of independent advice is strictly linked to the avoidance of constructive notice of the undue influence or misrepresentation of another person in relation to mortgages and similar surety arrangements.

raised allegations that representations had been made in respect of Swap 1 as to the profitability of these forms of swaps for all of BT's client base. Mance J. held that, had such representations been made, they ought to have been considered simply as "mere puffs" in any event. The important question of the suitability of Swap 1 was disposed by the finding of fact that DSS had had the nature of the product explained to it and therefore that it ought to have been able to comprehend the risks created by and the exposure of LIBOR to US interest rate movements.

In relation to Swap 2, Mance J. was more critical of BT because the seller's marketing material tended to emphasise the likelihood of gain rather than the risks of the loss, and further that that material might have given a misleading impression of the effect of the product. Mance J. found expressly that such a transaction would have founded liability for the tort of misrepresentation in respect of an inexperienced counterparty. On the facts, however, DSS appeared to be suitably experienced and diligent to form its own, independent assessment of the effect and risk of the swaps proposed by BT. Mance J. thus emphasises the relativity involved in assessing potential liability in this context. A counterparty which was demonstrably incapable of ascertaining the risks involved, or a counterparty which had not been as pro-active as DSS in pursuing these particular structures and relying more on the seller, would appear to have good grounds for a claim based on misrepresentation.

Second, in relation to deceit it was held on the facts that the particular employee of BT in question was honest at all times and had no intention to deceive DSS, nor had he been reckless as to whether or not he deceived DSS. Liability is therefore possible but subject to the buyer's claim coming up to proof.

Third, as to the enforceability of the alleged representation of replacement of the transaction at no cost, Mance J. found that it was implausible to suggest that BT had offered to replace the transaction. On the facts, it appeared that BT might have offered a restructuring package if the swap ultimately proved to be unprofitable for DSS. However, there was no such term demonstrated on the facts in respect either of Swap 1 or Swap 2.

Fourth, as to the general claim based on "breach of duty", Mance J. found that many of DSS's requirements for the swaps had not been communicated fully to BT to the extent that the were alleged by DSS to have existed in any event. Further, economists' predictions of the future movement of the US economy which had been supplied by BT were reasonably made and based on detailed research. As such, it was held, BT ought to have no liability based on the outcome of those economic predictions which had not, in themselves, caused DSS to enter into the transactions.

Importantly, in general terms, there was no duty on BT to act as general advisor to DSS. Furthermore, Mance J. was explicit in his finding that the courts should not assume such duties in all cases. A duty of care, under any of the heads sought be DSS, should be inferred only where it was justified on the particular facts. DSS were experienced in financial matters and as such should be expected to understand the partially speculative nature of the transactions. On these facts, it was held, there was no reason for BT to be saddled with a responsibility to advise DSS generally in the manner suggested by DSS's counter-claim.

Misrepresentation under statute

Section 2(1) of the Misrepresentation Act 1967 provides:

> "Where a person has entered into a contract after a misrepresentation has been made to him by another party thereto and as a result thereof he has suffered loss, then, if the person making the misrepresentation would be liable to damages in respect thereof had the misrepresentation been made fraudulently, that person shall be so liable notwithstanding that the misrepresentation was not made fraudulently, unless he proves that he had reasonable ground to believe and did believe up to the time the contract was made that the facts represented were true."

The provision only admits a remedy against the other contracting party. Indeed, it has been held that other persons, such as the other contracting party's agents, cannot incur liability thereunder.

Tort of negligent misrepresentation

In order to recover damages based on the tort of negligent misrepresentation, the plaintiff must establish that the defendant owed him a duty of care not to cause loss or damage of the kind caused by breach of that duty. Three criteria for the imposition of a duty of care in a particular situation: forseeability of damage, proximity of relationship and reasonableness.[227]

The first criterion is proximity. That is, the closeness and directness of the relationship between the parties, is particularly important. In evaluating proximity in the context of claims arising from inaccurate statements or advice, three factors are critical: purpose, knowledge and reliance: meaning the purpose for which the statement was made and communicated, the knowledge of the maker of the statement, and reliance by its recipient. The position was expressed as follows by Lord Oliver in *Caparo Industries plc v. Dickman*:[228]

> "What can be deduced from the *Hedley Byrne*[229] case, therefore, is that the necessary relationship between the maker of a statement or giver of advice (the adviser) and the recipient who acts in reliance on it (the advisee) may typically be held to exist where (1) the advice is required for a purpose, whether particularly specified or generally described, which is made known, either actually or inferentially, to the adviser at the time when the advice is given, (2) the adviser knows, either actually or inferentially, that his advice will be communicated to the advisee, either specifically or as a member of an ascertainable class, in order that it should be used by the

[227] See *Smith v. Bush* [1990] 1 A.C. 861 (H.L.) at 865 per Lord Griffiths and also *Caparo Industries plc v. Dickman* [1990] 2 A.C. 605.
[228] [1990] 2 A.C. 605.
[229] [1964] A.C. 465.

> advisee for that purpose, (3) it is known, either actually or inferentially, that the advice so communicated is likely to be acted upon by the advisee for that purpose without independent inquiry and (4) it is so acted on by the advisee to his detriment. That is not, of course, to suggest that these conditions are either conclusive or exclusive, but merely that the actual decision in the case does not warrant any broader propositions."

This statement has been extended. In considering the principle in *Hedley Byrne v. Heller*, [230] Lightman J. held[231]

> "It is clearly established that in a case such as the present, where the defendants have put a document into more or less general circulation and there is no special relationship alleged between the plaintiffs and the defendants, forseeability by the defendants that the plaintiffs would rely on the prospects for the purpose of deciding whether to make after-market purchases is not sufficient to impose upon the defendants a duty of care to the plaintiffs in respect of such purchases (see *Caparo Industries plc v. Dickman* [1990] A.C. 605). The imposition of a duty of care in such a situation requires a closer relationship between representor and representee, and its imposition must be fair, just and reasonable."

The burden of proving each ingredient of this cause of action is upon the plaintiff. The measure of damages is that appropriate to a claim in tort.

Damages for breach of contract

In principle, a statement in a document selling a derivative product or in some conversation between the trader and the counterparty may become incorporated as a term of the contract between the counterparties. This is over and above general damages for breach of contract.

DISHONEST ASSISTANCE IN A BREACH OF DUTY

It is possible that the obligations of a constructive trustee will be imposed on a person who has never had either ownership or possession of property held in trust or by a fiduciary. This obligation is imposed by dint of that person's 'dishonest assistance' in a breach of that trust of fiduciary duty.

The decision of the Privy Council in *Royal Brunei Airlines v. Tan*,[232] in the leading speech of Lord Nicholls, holds that a breach of trust by a trustee need not have been a dishonest act *on the part of the trustee*. Rather, it is sufficient that some accessory acted dishonestly for that accessory to be fixed with liability for the breach. The test as set out by Lord Nicholls creates a test of "dishonesty".

[230] [1964] 2 A.C. 465.
[231] In *Possfund Custodian Trustee Ltd v. Victor Derek Diamond* [1996] 2 All E.R. 774 at 782.
[232] [1995] 2 A.C. 378.

The test for "dishonesty"

Lord Nicholls is categoric that it is dishonesty that is needed to fix a third party to the trust with liability with reference to the beneficiaries under that trust. The trustee's state of mind is unimportant. The scenario is posited that the trustee may be honest but the third party is dishonest. Where the third party is acting dishonestly, that third party will be liable to account.

The test for "acting dishonestly, or with a lack of probity, which is synonymous, means simply not acting as an honest person would in the circumstance. This is an objective standard." (at p.386) The interesting notion is that dishonesty can be an *active* state of mind or alternatively a *passive* "lack of probity". It is suggested instead that this *active deceit* is the natural meaning of "dishonesty".

Lord Nicholls expands his discussion of "dishonesty" to consider the taking of risk. Risk is expressly encompassed within the new test. Lord Nicholls says:-

> "All investment involves risk. Imprudence is not dishonesty, although imprudence may be carried recklessly to lengths which call into question the honesty of the person making the decision. This is especially so if the transaction serves another purpose in which that person has an interest of his own." (at p.387)

The basis of liability is that a third party "takes a risk that a clearly unauthorised transaction will not cause loss ... If the risk materialises and causes loss, those who knowingly took the risk will be accountable accordingly." (at p.387) For these purposes it is said that "fraud includes taking a risk to the prejudice of another's rights, which risk is known to be one which there is no right to take." (at p.387).

The role of the "house bank"

Take all of the above but assume that the client is in the habit of relying entirely upon the financial institution for all of its financial requirements.

The inter-action between financial regulation and the common law

Financial Services and Markets Act 2000

The Financial Services and Markets Act 2000 ("FSMA 2000") came into full force and effect from 1st December 2001, after the passage of that Act on June 14, 2000.[233] FSMA 2000 created a new meta-regulator for financial services in the United Kingdom called the Financial Services Authority ("FSA") which absorbed within it

[233] Financial Services and Markets Act 2000, s.1(1).

the functions of a range of self-regulatory organisations and regulatory bodies considered below.[234]

FSMA 2000 is primarily enabling legislation in that it transfers the power to make regulations covering a range of issues previously covered by primary legislation either to the Treasury or to the FSA. Many of those specific contexts are not relevant to the area of derivatives – for example, the listing of securities, collective investment schemes, friendly societies and so forth – but to note that point is an important precursor to a discussion of this legislation as it will apply to financial derivatives. Given the enabling nature of much of the legislation it will therefore always be important to look to the regulatory rulebooks published by the FSA when considering the detail of financial regulation from time-to-time.

There is a further important feature of FSMA 2000 which relates to the overtly political and macro-economic objectives which are set out for the FSA. In short, the new regulatory body is charged with the preservation of the integrity of financial markets in the UK, the education of investors and the place of the UK within the global economy, as well as the oversight of the operations of market participants which characterised the previous legislative code.

The Financial Services Authority's general duties are prefaced with a statement that the FSA should "so far as is reasonably possible" act in a way which is compatible with its duties and in a which it considers to be most appropriate for the prosecution of those objectives.[235] The duties themselves are baldly stated to be: "market confidence, public awareness, the protection of consumers, and the reduction of financial crime".[236]

The market abuse code

One of the more contentious features of the 2000 Act is the code on "market abuse". The aim of this regime, which was introduced somewhat hurriedly into the legislation late in its passage through Parliament, is to expand the powers of the Financial Services Authority to prosecute those market participants – whether authorised or unauthorised under the legislation – outside the ambit of the ordinary criminal law for misfeasance in financial dealings. The importance of this regime is that it carries punitive penalties but that it does not replicate all of the protections and rights which are characteristic of the criminal law; this in itself may cause difficulties in relation to art 6 of the European Convention of Human Rights and its guarantees of a right to a fair trial. Its legislative purpose was therefore to make successful prosecutions for market abuse easier to obtain than had been the case under the pre-existing criminal law.

The market abuse regime relates to "qualifying investments" traded on LIFFE, the London Stock Exchange and other markets[237] where the behaviour in question would be regarded by "a regular user of that market" as a failure "to observe the standard of

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235 FSMA 2000, s.2(1).
236 FSMA 2000, s.2(2).
237 FSMA, s.118(1).

behaviour reasonably expected of a person in … their position in relation to the market".[238] A "regular user" is someone who is a "reasonable person who regularly deals on that market in investments of the kind in question"; the term "regular user" appears frequently in this code.[239] More specifically, the behaviour in question must exhibit three further features. First, it must be based on information which is "not generally available to those using the market" but which would be considered by a "regular user" of the market to be "relevant" to entering into transactions on that market.[240] Second, it must be "likely to give a regular user of the market a false or misleading impression" as to the supply of, demand for and value of the investments in question.[241] Third, the behaviour must of a kind that would be "likely … to distort the market" in question.[242]

To supplement this statutory code then there is a code of conduct which is required to be created by the Financial Services Authority under the auspices of FSMA 2000.[243] This code ("MAR 1")[244] requires that the instrument in question be one which is traded on an existing market and in which there is a continuing market. It is important to recognise that the types of behaviour which the Financial Services Authority intends to encompass within this regime relate not only to dealing directly in shares and other instruments but also to any behaviour which affects their value more generally.[245] Further, that behaviour may take place in another jurisdiction by nevertheless have an impact on instruments traded in the United Kingdom and so fall within the market abuse code.[246]

It is likely that the FSA will consider the application of particular market practices to the derivatives markets in deciding whether or not any particular activity is an abuse of a market. Those standards will clearly be of great importance in the application of MAR 1, given the importance given over in that code to close consideration of the norms usually applied particular markets[247] in particular when seeking to apply the "reasonable user" test outlined above. The standard used by the legislation of a hypothetical "reasonable user" of the market is intended to replicate the "reasonable man" test used frequently by the common law to establish a level of objectivity but while also retaining some recognition of the particular context within which that defendant is operating; thus creating a test more akin to the "average trader on the Stock Exchange" than "the man on the Clapham omnibus".[248]

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[238] FSMA, s.118(3).
[239] FSMA, s.118(10).
[240] FSMA, s.118(2)(a).
[241] FSMA, s.118(2)(b).
[242] FSMA, s.118(2)(c).
[243] FSMA, s.119.
[244] Published under the Financial Services Authority, Market Conduct Sourcebook Instrument 2001 (MAR 1).
[245] MAR 1, 1.11.8E.
[246] MAR 1, 1.2.9G.
[247] MAR 1, 1.2.3E.
[248] Cf. *Polly Peck v. Nadir* [1992] 4 All ER 769 where an objective test of reasonableness is used in relation to a claim for knowing receipt but where that objectivity is tempered by making reference to a "reasonable banker" in relation to financial transactions and not simply to an average person who may or may not have any banking knowledge.

Conduct of Business, post-FSMA 2000

Activities covered by the code

The Financial Services Act 1986 applied to "investment business" whereas the post-2000 Conduct of Business code divides between "designated investments" and "designated investment business". In general terms, this covers the same range of activities as the 1986 category for present purposes in relation to financial derivatives but does cover a broader range of deposit-taking and insurance activities outwith the 1986 categories.

Standard of disclosure

The Conduct of Business code is subject to a general requirement that when the seller communicates information to a customer, it must do so in a way which is "clear, fair and not misleading".[249] This principle is an advance over the 1986 code, particularly as affected in relation to *Bankers Trust v. Dharmala*.[250] In that case it was held by Mance J, partly in reliance on best practice established by the Bank of England London code, that the seller was not obliged to disclose all of the risks associated with a product to the buyer and also, importantly, that the seller's officers were entitled to recognise that it would make a large profit from the transaction at its client's expense without being liable for regulatory breach or for misrepresentation or fraud. Under this expanded principle of "clear, fair and not misleading" communications it is suggested that the seller would need to ensure that its marketing material and also any statements made at meetings were not capable of being misconstrued, that they were clear as to their effect, and that they were entirely "fair" with regard to the customer's own position. In this regard, the regulations provide that the seller must have regard to the level of knowledge which the buyer has of the transaction at issue when making written or oral communications.[251] Further, the seller must ensure that its officers do not take any inducements or "soft commissions" in effecting transactions.[252]

The post-2000 classification of customers

Customers are divided between three categories, roughly mimicking the 1986 categorisations. Those new categories are: market counterparties, intermediate customers and private customers. The categories are set out in chapter 4 of the FSA Conduct of Business rules. The purpose of the provisions, as outlined above, is to ensure that "clients are appropriately recognised so that the regulatory protections are focused on those clients who need them most"[253] with the result that there can be a regulatory "light-touch" in relation to dealings between market professionals. Therefore, the client must be categorised before any transactions are conducted.[254]

[249] COB, 2.1.3.
[250] [1996] C.L.C. 481.
[251] COB, 2.1.4.
[252] COB, 2.2.3.
[253] COB, 4.1.3.
[254] COB, 4.1.4.

It is possible for some private customers to "opt-up" so that they are treated as though they were intermediate customers provided that the private customer can be demonstrated to have "sufficient experience and understanding" to be so classified.[255] In this regard the seller must have warned the client in writing of the regulatory protections which the client stands to lose and that the client is then given sufficient time to consider its request to be re-classified.[256] Similarly a large intermediate customer can be re-classified as a market counterparty by virtue of such opting-up.[257] Finally, it is possible for market counterparties to be classified as private customers where it is considered that that is the more appropriate method of dealing with them.[258] In any event, the seller is required to keep a record of the classification together with "sufficient information to support that classification".[259]

At the outset, the seller must provide a private customer with its terms of business before any designated business is conducted,[260] whereas intermediate customers must only be so informed within a reasonable period of the beginning of designated business being conducted.[261] Those terms of business should include mention of the commencement of the terms of business, the applicable regulator, the investment objectives, any restrictions on the relevant designated business, which services will be provided, how payment for services will be effected, disclosure of any polarisation, whether the seller is to act as investment manager, any conflicts of interest, and whether or not the client has a right to withdraw.[262]

Suitability

In the pre-2000 SIB Conduct of Investment Business rules[263] there was specific mention of the concept of suitability. It is important not only that the product is suitable for its purpose, but also that the product is appropriate for the particular client and also that its advice to buy a particular product is given in a suitable way.[264] In relation to private customers, the seller is required to keep its treatment of such customers under regular review.[265] The polarisation rules require that the seller be giving independent advice wherever possible and that in circumstances in which it is acting otherwise than entirely in the clients interests – for example, if it is a market maker or acting as a discretionary fiduciary of some sort – then that status must be communicated adequately to the client in the context of the buyer's level of expertise.[266] The test adopted throughout chapter 5 of COB is that the seller must have taken "reasonable steps" – the expression adopted by the caselaw for example in relation to the enforcement of domestic mortgages against co-habitees of the

[255] COB, 4.1.8.
[256] COB, 4.1.9.
[257] COB, 4.1.12.
[258] COB, 4.1.14.
[259] COB, 4.1.16.
[260] Except where the client is habitually resident outside the UK.
[261] COB, 4.2.5.
[262] COB, 4.2.15.
[263] SIB Rules, Ch. III, Pt. 2.
[264] COB, 5.2.4.
[265] COB, 5.2.6.
[266] COB, chapter 5.

mortgagor[267] - in relation to its treatment of that client. An example would be the manner in which its officers induce clients to enter into particular transactions.[268] The type of reasonable steps which will be suitable are not susceptible of general definition but rather

> "will vary greatly, depending on the needs and priorities of the private customer, the type of investment or service being offered, and the nature of the relationship between the firm and the private customer and, in particular, whether the firm is giving a personal recommendation or acting as a discretionary investment manager."[269]

In so doing the firm is required to ensure that the product is the most suitable of that type of product for the purpose,[270] although another product would not be more suitable simply because it would be available at a lower price.[271]

Further the seller must ensure that the buyer understands the risks associated with the product[272] and give an appropriate risk warning. A risk warning in relation to derivatives is required to give notice to the buyer[273] in the form identified in Annex 1 to chapter 5 of COB.[274] This notion of sufficient risk warning was, of course, the acid test in *Bankers Trust v. Dharmala*[275] in deciding whether or not the buyer could be taken to have understood fully all of the risks associated with the interest rate swaps involved.[276]

In a derivative transaction under which a private customer has a contingent liability to make payments at some time in the future there is a requirement that a two-way customer agreement is put in place. This is part of the policy of protecting customer rights by, in part, ensuring the suitability of recommendations and discretionary transactions. The regulation of such agreements requires that there is no restriction on the part of the advisor to restrict its liability in respect of its obligations to advise without negligence and with due skill, care and diligence. With reference to complex financial products, which may involve derivatives, the advisor is required to ensure that the investment is suitable for that particular customer. Within the context of suitability is the need for avoidance of conflicts of interest. Regulation of conflicts of interest arises out of statute, regulatory rules and the common law.

Financial promotion

The principle change is the introduction of the "financial promotion" code, considered above, which requires that the selling of financial products be "fair, clear and not

[267] *Barclays Bank v. O'Brien* [1994] A.C. 180.
[268] COB, 5.1.11, 5.1.13.
[269] COB, 5.3.4.
[270] COB, 5.3.6(1).
[271] COB, 5.3.7.
[272] COB, 5.4.3.
[273] COB, 5.4.6.
[274] *Ibid*.
[275] [1996] C.L.C. 481.
[276]

misleading".[277] A failure to comply with this standard in relation to financial promotion leads to two possible conclusions outwith the ordinary, general law. First, disciplinary action by the FSA itself or, second, civil action brought by a private person under s.150 of FSMA 2000. This consolidates the approach to unsolicited calls or investment advertisements in the Financial Services Act 1986[278] with a new category of real time promotions.[279]

Risk management in the confirmation

Counterparty risk

•Is the counterparty known ('know your client')?
•Is the counterparty in a jurisdiction in which we can deal?
•Can we deal in the specific product in that jurisdiction?
•Do we need any approvals? (e.g.: central banks, government departments)
•What laws are there restricting capacity to enter into derivatives to which the counterparty is subject?
•Will the counterparty provide documentation to prove its capacity to enter into the transaction?

Documentation

•Is there a Master Agreement in place with the counterparty?
•If not, what particular legal concerns remain outstanding? Does the confirmation address them?
•Will all transactions be capable of netting on insolvency under this Master Agreement?

Credit

•Has the requisite credit survey approved the transaction? i.e.: will the counterparty be able to pay?
•What credit support is the counterparty willing to provide?
  •guarantee
  •cross default
  •credit event upon merger
  •cross acceleration of debt
  •collateral
  •margin

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278 Financial Services Act 1986, ss.56 and 57.
279 Financial Services and Markets Act 2000, s.21.