Equity, Restitution and Property after *Westdeutsche Landesbank v Islington*

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This paper was delivered at a staff seminar at QMUL in March 1998

The local authority swaps cases have spawned an enormous commentary on both the public law aspects and on the issues concerning equity, restitution and property which they also raised. Less has been said about the financial context of those decisions, nor about whether or not the brand of equity propounded by the majority of the House of Lords in *Westdeutsche Landesbank* is a suitable mechanism for dealing with such issues. The restatement of the core rules of equity in the speech of Lord Browne-Wilkinson in *Islington* created a test based on the conscience of the defendant to any claim. It is submitted that this concentration on knowledge of a factor which ought to affect a person's conscience is not the most appropriate mechanism for allocating personal and proprietary claims in the context of commercial and financial transactions. In particular, Lord Browne-Wilkinson held that a proprietary remedy will only be imposed in circumstances where the defendant has knowledge of the factor which is alleged to impose the office of trustee on him. It is submitted that these principles restrict the potential intervention of equity to such a narrow range of cases that the mutual intentions of parties to commercial contracts will frequently not be enforced by either the rules of common law or of equity.

Within this short statement of the majority opinion is hidden a number of interesting sub-texts. First, the war between 'equity lawyers'[1] and 'restitution lawyers'. Second, the inadequacy of English law's fetish for identifiable property, rather than value, before permitting the award of an equitable remedy or trust. Third, the nature of money as property in English law. Fourth, whether or not English law is really providing rights *in rem*, by reference to 'a thing', or simply personal rights against other persons founded on some 'value'. Fifth, the role of the courts as an ad hoc regulator of unregulated, dynamic financial markets.

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

[1] If that is not an ugly contradiction in terms.

Furthermore, it is argued that neither equity nor the law of restitution, as currently understood, are suitable for the resolution of disputes involving financial agreements because they are only able to operate in respect of identifiable property. It is argued that the 'property' typically at issue in financial market contracts will not comply with the received notion of money as a chattel.

The litigation

There are joined appeals of Westdeutsche Landesbank Girozentrale proceeding against the London Borough of Islington ('*Islington*')[2] and Kleinwort Benson proceeding against Sandwell Borough Council ('*Sandwell*')[3]. 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. Two of these appeals were brought by Kleinwort Benson against Birmingham City Council ('*Birmingham*')[4] and against South Tyneside Metropolitan Borough Council ('*South Tyneside*')[5]. All this is apart from the cases on capacity of local authorities to enter into transactions, *Hazell v. Hammersmith & Fulham* [6]('*Hazell*') and the contracts for differences cases, *Morgan Grenfell v. Welwyn Hatfield DC and others*[7] ('*Welwyn*').

<u>The context of local authority funding</u>

A word should be said about local authority funding to set the scene.[8] At a time of rigorous rate-capping, the local authorities in the UK 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.

The interest rate swap enabled authorities to hedge the risk associated with their interest repayments and to speculate on interest rate movements at the same time. Many of the interest rate swaps that were used were 'deep discount' swaps which enabled the authorities to receive a lump sum, in effect a loan, which was repaid by calibrating the periodical swaps payments owed between them and the banks to repay the capital sum over time. This raised extra debt funding outside the limits of the 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

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[2] [1994] 4 All E.R. 890, Hobhouse J., CA; [1996] AC 669, HL.
[3] [1994] 4 All E.R. 890, Hobhouse J.. The *Sandwell* action did not proceed beyond first instance.
[4] *Kleinwort Benson* v. *Birmingham City Council* [1996] 4 All E.R. 733, CA, on appeal from Gatehouse J., (unreported).
[5] *Kleinwort Benson* v. *South Tyneside M.B.C.* [1994] 4 All E.R. 972, Hobhouse J..
[6] [1991] 1 All E.R. 545, HL.
[7] [1995] 1 All E.R. 1, Hobhouse J..
[8] 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*.

straightforward vanilla interest rate swaps as the market would ordinarily understand them.[9]

These arrangements collapsed when some authorities' speculation on interest rate movements meant that they ended up owing ever more money under their debt portfolios than they had owed originally. The appalling impact on the finances of the London borough of Hammersmith and Fulham led to the litigation which caused the House of Lords to rule that these products were ultra vires UK local authorities.[10] It was the auditor for the authority which commenced the action. Hammersmith & Fulham became the lead case, which was unfortunate given that Hammersmith & Fulham had entered into more interest rate swap transactions than all of the other 77 local authorities in the UK put together.

It was generally accepted during that litigation that Hammersmith & Fulham was speculating in the main when it entered into those products.[11] This suspicion has surrounded derivatives ever since their promulgation as a highly volatile, complex and expensive form of risk management or portfolio enhancement in the early 1980's.[12]

There were a number of interest rate swaps outstanding between local authorities and the 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.'[13]

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

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[9] For a more detailed discussion of the operation of interest rate swaps see '*The Law on Financial Derivatives*', 1st edn., Alastair Hudson (Sweet & Maxwell, 1996) 11-33 and generally; or for a briefer account see 'The Legal Aspect of Financial Derivatives', *Business Law Review*, Alastair Hudson, Vol. , October 1996, 199, 199-201.

[10] *Hazell v. Hammersmith & Fulham* [1991] 1 All E.R. 545.

[11] *Hazell v. Hammersmith & Fulham* [1991] 1 All E.R. 545, 553, *per* Lord Templeman; *Westdeutsche Landesbank Girozentrale v. Islington LBC* [1994] 4 All E.R. 890, Hobhouse J.; and *Morgan Grenfell & Co Ltd. v. Welwyn Hatfield District Council & others* [1995] 1 All E.R. 1, Hobhouse J. generally.

[12] Indeed the literature in defence of the derivative as a useful tool of prudent financial management is still being produced. See most recently *Merton Miller on Derivatives*, Merton H. Miller (Wiley Investment, 1997). For a more conservative approach and some suggestions for more prudential regulation, see '*The Law on Financial Derivatives*', 1st edn., Alastair Hudson (Sweet & Maxwell, 1996), Part 6, pp.199-229.

[13] *Hazell v. Hammersmith & Fulham* [1991] 1 All E.R. 545, 552, *per* Lord Templeman.

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.[14] It is also significant to note that this particular authority had entered into far more of these transactions than all of the other authorities put together.

There is an express finding of fact by Hobhouse J. on the basis of oral evidence given in his court by an employee of the authority that:

> '… the purpose of those [interest rate swap] contracts was not any aspect of debt management or the hedging of any loan contracts; it was simply another device which was designed to increase the revenue available during the current year albeit at the cost of reducing the net revenue available in later years.'[15]

What is not clear is what would have happened if the lead case had involved a local authority which could have demonstrated that it *was* using interest rate swaps solely for the purposes of managing the cost of funding its debt. What is frequently forgotten is the breadth of the legislation that was at issue. Under s.111(1) of the [Local government Act] 1972:

> '… a local authority shall have power to do anything (whether or not involving expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions.'

On this basis, the authorities themselves, the financial institutions and the Audit Commission came to the view that local authorities would be able to enter into interest rate swaps for debt management purposes. Indeed, it would seem to be logical that derivatives should be used to control exposure to movements in interest rates in the same way that umbrellas are carried to guard against rain.[16]

It is submitted that the only possible reading of this litigation and the speech of Lord Templeman in the House of Lords in *Hazell* is that the courts were concerned to guard against a particular risk rather than to deal with a specific failure on the part of one particular local authority to act prudently in the management of its finances.

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[14] Always presuming that anyone remained living in the borough after the removal of services and exponential rise in local rates.

[15] [1994] 4 All E.R. 890, 904, Hobhouse J.

[16] The case of *Brane v. Roth* (Indiana Court of Appeals) […] is instructive in this context. In that case a director was held liable in negligence for failing to protect the company against movements in interest rates by the use of interest rate swaps. This case illustrates perhaps the counter-view that where there is an exposure to market movements, the law ought to require market participants to act prudently in the use, rather than the avoidance, of financial derivatives. In respect of the growing context of prudence measured by reference to market usage, see the comments of Hoffmann J. that the duties of a trustee with reference to the proper investment of a trust fund are to be considered in the light of 'current portfolio theory', in *Nestle v. National Westminster Bank* (June 29, 1988) [1993] 1 WLR 1260, commented on in Underhill and Hayton '*Law of Trusts and Trustees*' (Butterworths, 1995), 599, also noted in Hayton and Marshall '*Commentary and Cases on the Law of Trusts and Equitable Remedies*' (Sweet & Maxwell, 1996), 595-7.

Islington: the deep discount swap

The Islington transaction is the prime example of the use of the deep discount swap to achieve off-balance sheet funding for the authority.

Back-to-back structure

The transactions entered into between Westdeutsche and Islington were arranged through an intermediary financial institution (Morgan Grenfell) seeking to match the authority's needs with a lender's available liquidity. In the early days of the swaps markets, all transactions were arranged by financial institutions who found two parties with equal and opposite requirements.[17] The commercial nature of the structure is important. Given that swaps are transacted with the primary aim of managing risk, the allocation of risks is central feature of the negotiations and documentation. None of the courts in the swaps litigation paid any attention to the pain-stakingly crafted documentation.[18]

Hobhouse J. found that Westdeutsche's employee considered 'commercial and solvency risk' on entering into the transaction - he did not look to the 'legal risk' of entering into this arrangement with a UK local authority. It emerges from the judgement that there were 'two contracts … They were essentially back-to-back contracts.'[19] This back-to-back arrangement, although it is not made explicit in the judgements, refers to the use of the intermediary Morgan Grenfell in setting up the deal. Under one contract Westdeutsche was the fixed rate payer at a rate of 7.5% and Islington paid a floating rate of sterling LIBOR. On the second contract, Westdeutsche paid a floating rate of sterling LIBOR to and Morgan Grenfell paid 7.74% to Westdeutsche.[20]

The originally mooted transaction was four times the size of the deal that was ultimately brokered. Morgan Grenfell matched Westdeutsche's preparedness to lend the lump sum and manage the authority's interest rate risk, with Islington's desire to borrow.

The contracts were 'on the BBAIRS terms with a notional principal amount of £25m'.[21] However there was a difference from the normal BBAIRS terms in that 'it

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[17] This was particularly true of the early currency swaps which were transacted to avoid exchange controls. Party A in country A needed the currency of country B. Financial institutions would locate a Party B in country B who needed currency A. Both parties would borrow in their own currency and then, in effect, assign their rights to the moneys borrowed in favour of the other party - literally a 'swap'. The intermediary would take a fee. The net result was the acquisition of funding in another currency without breaching exchange controls.

[18] The implications of this omission are considered in detail below.

[19] [1994] 4 All E.R. 890, 901, Hobhouse J.

[20] The result of this mismatching was that Westdeutsche received a 'turn' of 0.24% to encourage it to enter the transaction. It is assumed that Morgan Grenfell received either a flat fee or, more likely, its own turn priced into the product.

[21] The use of the British Bankers Association standard terms for interest rate swaps is unusual given the more general use of International Swaps and Derivatives Association ('ISDA') standard terms and the fact that Westdeutsche and Islington had signed a modified form of the ISDA 1987 Master Agreement for this type of transaction.

did not acknowledge any contemplation by the floating rate payer that the fixed rate payer might have any back-to-back agreement with another party'.[22] The importance of this deviation is that a hedging agreement has been held not to be expressly within the contemplation of the parties to the main contract.[23]

Payment Netting

While we are not given any of the detailed terms of the contracts, we are told that 'the contract only imposes a liability to pay net sums and that was all that was actually paid.'[24] This tells us that payment netting was in place between the parties.[25] That is, while the floating rate and fixed rate payers owed each other amounts in gross on the same date, the contracts provided that only the party owing more that it was owed should pay a net amount equal to that surplus to the other party. This is a significant part of structuring this interest rate swap. Only one payment is ever actually made although two amounts are owed. It is therefore possible that on some occasions no surplus amount will be owed where the gross obligations set off exactly. The manner in which this interest rate swap was priced meant that it would have required a large movement in sterling interest rates to achieve that result.

Analysis of the Deep Discount structure

There was an important further facet to these transactions. Most interest rate swaps involve only a payment of income amounts which are calculated by reference to a fixed notional amount - as discussed above. However, to give the local authorities the lump sum injection of cash they needed, a deep discount payment was made to the local authority. This peculiar feature, it is submitted, marks this transaction out from the norm in any event. As Hobhouse J. explained it:-[26]

> '… each [agreement] provided for the fixed rate payer to pay to the floating rate payer on the commencement date, 18 June 1987, an additional sum of £2.5m. Under the scheme of the contracts this was expressed to be the first of the fixed rate payments and it was calculated against a discount in the later fixed rate payments. If there had been no discount, the appropriate fixed rate of interest for the ten-year period would have been 9.43% pa. £2.5m represented the advancement of periodic semi-annual payments of 1.93% pa on £25m over ten years.'

Loan or swap?

[22] [1994] 4 All E.R. 890, 905, Hobhouse J.
[23] *Kleinwort Benson v. Birmingham C.C.*, op cit..
[24] [1994] 4 All E.R. 890, 905, Hobhouse J.
[25] It is important to distinguish 'payment netting' during the life of transactions from 'close-out netting' which occurs on the termination of the contractual agreement between the parties on bankruptcy or the happening of some other event of termination.
[26] [1994] 4 All E.R. 890, 901, Hobhouse J.

One analysis of this structure could clearly be that a loan is made to the authority which is then repaid by structuring the level of the periodical payments. However, Hobhouse J. held that:-

> 'The contracts did not purport to be and were not expressed as contracts of loan but simply as interest rate swap contracts. This feature was vital to the reason of Islington for entering into the swap contract.'[27]

There is a paradox here. The up-front payment by Westdeutsche is accepted as having been the *sine qua non* of the transaction for Islington. Without that payment, there would have been no deep discount swap. As discussed above, the local authorities' primary motivation was obtaining debt funding within a debt management package. The authority was keen to avoid breaching the rate cap by borrowing more money directly - any influx of new money had to be packaged as something other than a loan. What is not clear is why Hobhouse J. is necessarily prepared to accept this assertion of form over substance. It appears to have been agreed between the parties that the structure was a swap not a loan. Had the parties contended otherwise, the contract would have been void as offending the rate capping provisions - leading to penalties on the local authority and, potentially, the councillors personally.

It is accepted in the House of Lords, where the point was not a point at issue, that there are loan-like features in this deep discount structure. In the speech of Lord Goff, the following, revealing passage arose:-

> 'I incline myself to the opinion that a personal claim in restitution would not indirectly enforce the ultra vires contract, for such an action would be unaffected by *any of the contractual terms governing the borrowing*, and moreover would be subject (where appropriate) to any restitutionary defences … *the lender* should not be without a remedy.'[28] [author's emphasis]

And later in the same speech:-

> '… the fixed rate payer may make an upfront payment to the floating rate payer, and in consequence the rate of interest payable by the fixed rate payer is reduced to a rate lower than the rate which would otherwise have been payable by him. *The practical effect is to achieve a form of borrowing* by, in this example, the floating rate payer through the medium of the interest rate swap transaction.'[29] [author's emphasis]

The important point made by Lord Goff is that the transaction entered into in this situation was, in reality, a form of borrowing packaged as an interest rate swap. The purpose of the transaction was to obtain preferential rate funding more than to manage existing debt.

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[27] [1994] 4 All E.R. 890, 901, Hobhouse J.
[28] [1996] 2 All E.R. 961, 972-3.
[29] [1996] 2 All E.R. 961, 965.

There can be little doubt that the deep discount payment does bear striking similarities to a loan. It is an amount of money paid by one party to another, on the basis that that other will make repayments of that amount periodically - some of those repayments being made by set-off of other obligations. It would appear that analysis accords with the basic definition of a loan.

The only obstacle to the loan analysis of this structure is the availability of set off. However, a set off is simply a payment of value on a net basis. Therefore, there seems little problem with the contention that the deep discount swap looks like a loan. Indeed, rather than the contracts looking like they were not a loan, *the very purpose* of the arrangement was to acquire lump sum funding for the authority it a way that would appear to elude legislation governing local authority funding. However, Hobhouse J. accepts, without more, that the money was not intended as a loan - despite the 'vital feature' of the deep discount payment.

There can be little doubt that the structure does include the typical characteristics of an interest rate swap.[30] However, the *Islington* litigation is therefore something of a chimera for derivatives lawyers. It relates to a one-off transaction which is used only rarely in the modern marketplace. Where its principles come into importance are with reference to payment of compound interest, provision of collateral, and contracts dealing with physically settled products. The *Islington* decision has broader ramifications for the derivatives lawyer (as well as general commercial lawyers) beyond its own limited facts.

Therefore, the transaction should properly have been seen as an illegal loan (contrary to the rate-capping legislation) and a separate interest rate swap held void ab initio. It is submitted that the restitutionary approaches to these problems would then be different from the all-in-together approach actually adopted by the courts.

The place of Equity

The English principles of Equity were formulated primarily to regulate the conduct of family trusts and rights in homes from the eighteenth century and beyond. The norms which were created in respect of the availability of proprietary rights and compound interest were orientated around domestic, factual situations. As Lord Browne-Wilkinson himself pointed out in *Target Holdings v. Redferns*, those 'traditional trusts rules' sit uncomfortably with the complex, cross-border markets of the late twentieth century. In the financial markets affected by the decisions of the swaps cases, English law is applicable as a means of convenience. Counterparties which are often not incorporated or organised in England and Wales but which choose the English commercial law rules to govern their contract, are therefore caught up in this web of ancient English cultural norms affecting their entitlement to market standard rights in property and commercial rates of return. It is possible that neither party to a contract will ever inter-act physically in England or Wales, they may have no connection with the jurisdiction or currency, but may choose the system of law out of convenience.

[30] Although it is not apparent from the cases as reported, which risks were sought to be managed by the use of the swap - nor whether they had some alternative, speculative strategy.

The status of English law is therefore of extra-territorial importance. In moulding the principles of equity, it is important to recognise context.

The development of equitable principles in relation to commercial transactions has seen a greater 'concretisation' of the tests used by the courts and a movement away from the application of general principle to context. Recent cases, such as *Tan* and *Islington* have typified a judicial desire to impose stricter rules on the nature of equitable responses than are suggested by the list of core equitable principles reproduced in *Snell's Principles of Equity* where vague poetic and normative prescriptions such as 'coming to Equity with clean hands' have long formed the lifeblood of the equitable counter-point to the rigours of the common law. Indeed, areas of the common law such as the tort of negligence have seen an ever greater relaxation of principles and rules as the common law and equity appear to be moving in opposite directions.

The further development is the growth of adherents to restitution among the commentators, to the chagrin of traditionalist equity lawyers. The stage was set in *Islington* for disagreement between the grand-father of restitution, Lord Goff, and the new broom of Lord Browne-Wilkinson. In a number of House of Lords cases these two had taken different approaches to the appropriate use of equity and of trusts implied by law.[31] The notion of a law based on reversing unjust enrichment has been developed by Prof. Birks in a number of publications. Indeed, his work is considered in close detail by the House of Lords in determining which ideological route is to be favoured in deciding the swaps cases. Much of the later discussion in this [work] takes up the threads of these distinctions and segregates them out into a series of different "approaches" to factual circumstances such as those raised by *Islington*.

Prof. Birks has referred to there being little difference between the speeches of Lords Goff and Browne-Wilkinson in the interpretation of the equitable and restitutionary techniques available in *Islington*.[32] Birks is somewhat dismissive of the extent of any change introduced by Lord Browne-Wilkinson.[33] It is submitted, however, that the opposed speeches in *Islington* should be seen as the battleground for three generations of lawyers to consider the position of equitable proprietary remedies. Their various approaches to the problem at hand are symptomatic of their generational attitudes. In that context, there were no surprises in the decision nor in the rationales of the decisions.

The first approach to the issues appealed to the House of Lords and considered by the judicial committee is identified as being the conservative Restitution Approach as set out in the partially dissenting speech of Lord Goff.[34] There are areas of agreement in it with the leading speech of Lord Browne-Wilkinson. Technically speaking Lord Goff's dissent is only partial - specifically he dissents on the question whether or not compound interest should be made available as a matter of providing justice between the bank and the local authority. Lord Goff preserved the approach of the classical

[31] See also *Tinsley v. Milligan.*
[32] [1996] RLR 3.
[33] [1996] RLR 3.
[34] This is considered below in the 'Restitutionary Approach'.

restitution lawyer in looking at problems of restitution of mistaken payments from the analysis of existing precedent and the need to achieve a 'just result' .

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

In the inter-generational conflict identified as existing between the various approaches, it is the equity approach which emerged as the one which became law. While the House of Lords has accepted the existence of a law of unjust enrichment in the wake of *Lipkin Gorman v. Karpnale* and *Woolwich Building Society v. IRC*, it is not clear what form that new development will take. At one level, it may remain a marginal doctrine which represents a modern statement of long-established doctrines such as money had and received which are clearly restitutionary in intent. Alternatively, many commentators see it as a means of displacing existing principles of equity, of the law of property, and many doctrines classically understood as being part of the law of contract or of the law of tort. One message to emerge from *Islington* is that traditional ideas of equity and trusts remain the proper means for dealing with unconscionable conduct and enforcing the claims of beneficiaries against the title-holders of property at common law.

However, the decided cases have not analysed swaps contracts in the way in which their substance demands that they be construed.[35] The adoption of an implied understanding of a swap as being a single, executory contract rather than an amalgam of separate payment obligations has led the courts to treat all swaps as capable of simple rescission and restitution by payment of money and simple interest. Further, the courts has considered all swaps to be identical transactions even though the substance of each contract at issue is disclosed as having been materially different by the courts themselves. For the rapidly developing derivatives markets, these unsophisticated analyses of complex, idiosyncratic transactions will continue to hamper the availability of proprietary rights, credit support and other risk management techniques in future cases.

[35] This issue is considered in detail in *Swaps Pricing Models* below.

Indeed, the nature of the property at issue[36] is not considered at all by the courts. In all of the swaps cases the cash settled amounts at issue between the parties were not considered in terms of being specific items of property. It was assumed that all money was inter-changeable, whereas the property at issue ought to have been properly analysed as made up of distinct choses in action in the form of amounts of value attributed to electronic bank accounts. As considered below in *The Concept of Money*, the understanding of the property at issue as being a series of mutual obligations manifested by complex choses in action would require a different approach to that taken by the courts in the swaps cases. Similarly, a bi-cameral form of set-off on each swap payment date and provision for set-off in the event of bankruptcy was not taken into account in considering the contingent nature of those choses in action. Consequently, the issue as to availability of proprietary rights over such choses in action and of compound interest of such value is not related to the nature of the modern financial world beyond English law's attachment to the concept of money as a tangible item of property.

The nature of the OTC derivatives market

It is a truth universally acknowledged that derivatives are 'difficult'. The approach of the courts in the swaps cases is to cluster round a single definition of the interest rate swap provided by Lord Templeman in *Hazell*. In on other commercial context would the English courts assume that two transactions had the same structure and were susceptible to the same legal analysis simply on the basis of a label which had been applied to them. The underpinning of English commercial law is that the courts should look to the substance and not simply the form of agreements. As such it is disappointing that financial derivatives are not subjected to a more detailed scrutiny that that required by Lord Templeman for the purposes of the appeal in *Hazell*. On this precarious analytical footing, derivatives are already forming the subject matter of House of Lords and Court of Appeal decisions. The financial derivative remains free of systematic regulation at the time of writing, with no indication of any plans to introduce such regulations. Rather the UK- and EC-based regulatory bodies have tended to deal with the derivative to the extent that it would fall within their remit in any event. As yet the regulators in those jurisdictions have not embarked on the sort of analytical questions which are being considered by the US regulators as to whether or not derivatives products should be properly analysed as either securities or commodities in all or some circumstances.

The marketplace relies on the opinions of practising lawyers in controlling the varied risks that the financial derivative generates. The cost effectiveness of the products depends upon the risk management of a number of different factors. Credit risk, the ability to enforce obligations on insolvency and the risk of counterparties failing to pay in any event under the contract are at the core of commercial purpose.

While the caselaw has, for the most part, failed to give effect to the commercial purpose underlying derivatives contracts, the malleability of derivatives products contains the ability to circumvent many of these prohibitions. For example, recent decisions, such as

[36] Considered below in *The Concept of Money*.

that of the House of Lords in *Islington*, have altered the market's perception of the availability of restitutionary remedies.

Interest rate swaps

The modern form of swap is an exchange of cash flows between parties. The following example is a common form of strategy in a market in which interest rates are considered likely to rise over the long-term. Where A plc is borrowing money at a floating rate of LIBOR + 100bp (that is, 100 basis points above the London inter-bank offered rate at any given time), it will wish to guard against future increase in interest rates. There are two reasons for this. First, it will want to avoid the cost of higher interest rates. Second, it will wish to be able to calculate with certainty its future cash out-flow in interest rate payments in forming its medium and long-term corporate strategy. Therefore, it will seek to swap its floating rate debt for fixed rate debt.

A has an existing debt obligation. Therefore, it is required by the loan contract to make payments of LIBOR + 100bp calculated by reference to the size of the loan. If B Bank agrees to put in place an interest rate swap, B Bank will pay that amount of LIBOR + 100bp to A so that A can satisfy its ordinary debt interest obligations. A will pay B a fixed rate of interest in return. A's expectation is that LIBOR + 100bp will be higher than the fixed rate of interest it is paying to B.

It is important to point out at this stage that several issues arise, all of which will be considered in greater detail below. First, the parties owe each other the full amount of the payments calculated by reference to the actual debt. Therefore, there are mutual debts owed between the parties. Second, these mutual debts are owed, usually, simultaneously on a series of payment dates throughout the life of the transaction.[37] Third, while there are mutual debts owed, the parties only actually *pay* a single, net amount between them being the difference between the amounts owed. Fourth, the negotiations between the parties as to the economic terms of their agreement and manner in which those terms are priced, are based on a segmental analysis of contract, rather than on a single executory contract approach. The impact of this particular concern is considered below with respect to Swap Pricing Models.

A brief word should be said about the status of the bank under this type of transaction. At first blush it would appear that A gains and B loses on the transaction. A number of points should be made to demonstrate why the transaction is not entirely to B's disadvantage. First, A and B may simply have different views on the direction in which interest rate will move in the future such that each party is taking a view of the risk of rate movements. Second, B can probably borrow money in the money markets more cheaply that A. This may be because B has a better credit rating and is better known in the marketplace. More likely B will be borrowing in bulk across all of its banking business and therefore can acquire funds more cheaply on a volume basis in the money markets than A can acquire through occasional retail borrowing. Third, in pricing the

[37] In the type of transaction considered in this example, those swap payment dates will mirror the payment dates for interest on the underlying loan.

transaction B will include a spread (or profit margin) in the level of the fixed rate which A will pay to B throughout the life of the transaction.

The fourth criterion relates to the hedging strategy of B and necessitates a three-dimensional view of the manner in which B runs its derivatives business. The interest rate swap market grew out of the parallel and back-to-back loan structures discussed elsewhere in this section. Those structures required two parties to be brought together to transact business on an equal and reciprocal basis. In that way banks have intervened in that structure by replacing the need for two arm's length parties with equal and opposite requirements by making up one side of the bargain itself. In the modern context, banks can be considered to be warehouses for cash flows of this sort. Where A requires LIBOR +100bp, B should be able to dig into its warehouse and find a cash flow (or aggregate of cash flows) equivalent to LIBOR + 100bp which can be passed on to A. Therefore, the management of B's business should aim to produce a balanced 'swap book' whereby business is transacted which is capable of off-set across transactions.

The following example explains the way in which this is achieved. C plc seeks to issue bonds to the market to raise finance. Due to its credit rating, the market requires a coupon of 8% to be paid on those bonds to ensure a sufficient subscriber base. C wishes to enter into an interest rate swap with B Bank to lower its effect cost of funding this debt. B agrees to pay the 8% coupon to C in return for the floating rate of LIBOR + 200bp calculated by reference to the total size of the bond issue. B is therefore receiving an inflow of 8% which it believes will match its obligation to A.[38]

B will calculate the aggregate of its outflows and inflows across the swap book on (at least) a daily basis to ensure that all obligations are matched by amounts owing, together with a required margin of profit. To the extent that there are positions which are not matched by reciprocal, arm's length transactions, B Bank will enter into hedging transactions of its own. This is achieved by contracting derivatives with other financial institutions such that its obligations are hedged with acceptable modelling predictions and liquidity requirements.

The day-to-day operation of the swaps market is dependent on this three-dimensional view of the use of derivatives products. One of the commonest criticisms of the English courts' treatment of these products is that each transaction is seen as being a distinct contract unrelated to these other inter-linked obligations. This theme is resumed in the context of Swap Pricing Models below in the context of the factors which the parties necessarily take into account in assessing the size and nature of payments to be made between the parties.

It is important to indicate that the majority of swaps transactions are not transacted by reference to specific amounts of debt and do not require that the whole of those amounts of money are transferred. Rather, swap payments are calculated by reference to notional amounts of money. The size of this notional amount may bear reference to some existing

[38] Often this form of swap is contracted as a part of the bond issue between the issuer and one of the lead managers. That it is embedded in the underlying bond issue leads to it being described as an 'embeddo' in market parlance.

obligation but it is not necessarily linked directly to it. There is no general rule in this context, only a need to examine each situation on a case-by-case basis.

The forward

The forward is an obligation to make a payment or delivery at a given price on a given date (often in a given place) in the future. The future is the same structure organised on an exchange. The sense in which the term 'forward' will be used in this context refers solely to transactions which are contracted off-exchange, or 'over-the-counter'. It is possible to analyse a forward as being made up of two options: one a call option sold to a party to demand payment or delivery and on the other hand a put option which entitles the other party to make the payment or delivery in return for payment. A swap is, by one analysis,[39] a series of forward contracts to pay or to receive an amount of money on a particular date according to the movement in a chosen interest rate. Therefore, a swap could, by extension, be analysed as a series of put and call options to receive or to pay an amount of money on a particular date, with reference to a particular interest rate.[40]

The products are all rights or obligations to pay or to receive sums of money by reference to a floating indicator, whether that be an interest rate, a share index, or the price of a bond or commodity index.

A forward conveys the right to purchase or sell a specified quantity of an asset at a fixed price on a fixed date in the future. In exchange traded futures contracts, which are a standardised form of forward contract, the quantity of the underlying asset to be delivered per contract is fixed, as is the underlying financial instrument or index, the minimum price movement for the contract and the life of the contract. In a forward agreement, these elements are at large for negotiation between the parties.

The prices are quoted as an amount (100) less the implied interest rate on that instrument. Therefore, the price of a futures instrument moves in inverse correlation to movements in interest rates. This inverse movement against interest rates, makes forwards (and particularly exchange traded futures contracts) the ideal instrument to hedge against movements in interest rates. If interest rates falls and the price of futures therefore rises, there is an inverse correlation that means a movement in one will be compensated by an opposite movement in the other. As a result, one is a useful instrument in hedging a movement in the other.

Swap Pricing Models

One element of the swaps market which was not considered in any of the swaps cases was the mechanics behind the products. While there has been some discussion of the commercial purposes behind the swaps used by the local authorities, there was no consideration in any of the judgements as to the financial structuring issues in putting

[39] See the discussion in *Swaps Pricing Models* below.
[40] *Swaps and Derivative Financing*, Satyajit Das, 2nd ed. (Irwin, 1994), 80-88.

those products in place nor as to the legal analysis propagated by the documentation. The issues of documentation and of legal analysis are considered separately. This section considers the manner in which swaps are priced.

There are two basic approaches to pricing swaps. The first is to consider them as made up of separate financial forwards in the manner considered above. The second is to consider them as effecting capital markets arbitrage.

The financial futures approach sees each separate swap payment as an obligation to pay an amount of money on a given date calculated by reference to a rate of interest and a notional capital sum. On each payment date there are two financial forwards: one owed by the floating rate payer and the other owed by the fixed rate payer. The payment netting provisions mean that only the surplus represented by the difference between the two amounts owed reciprocally.[41] Thus, rather than attempting to price the swap on a single contract approach, the transaction is divided up into segments.

The swap must be seen as an integrated financial instrument made up of a number of distinct segments. Each payment date is treated as a distinct financial product for pricing purposes. This process is generally known as 'financial engineering'.[42] From the point of view of the financial engineer each segment must receive a separate pricing analysis according to its commercial underpinning. Das refers to this segmental approach as 'decomposition' of the swap.[43] The pricing for a swap based on a commercial need to re-calibrate a debt obligation will be based on a combination of interest rate forwards, FRA's and possibly vanilla interest rate swaps.[44] A contingent contract would have an element of the option priced into it as though it included an independent option. Similarly, the structuring of currency swaps are made up of a series long-term foreign exchange contracts, or options to acquire foreign currency. In either case, there may be features which ensure that there are levels above which and below which performance of the swap contract is restricted: such elements are priced as though independent caps, collars and floors.

Each of these individual components have their own pricing methodologies. In pricing a swap, the applicable forward and option prices on the prevailing capital markets are incorporated into the structure. Currency swaps adopt the price of options contracts on the foreign exchange markets. In considering the price of options and forwards the familiar Black Scholes Option Pricing Model is adopted as for open market contracts. Similarly, the put-call parity will be included to account for the mathematical relationship between forward contracts and options. Therefore, the ultimate price assigned to the swap contract is the result of an aggregation of the distinct prices of each of these market instruments. Indeed Das describes swaps as being 'portfolios of forward and option contracts'.[45]

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[41] As considered below this means that there is a possibility that, if the amounts set off exactly, no amount will actually be owed at all.
[42] *Swaps and Derivative Financing*, Satyajit Das, 2nd ed. (Irwin, 1994), 114.
[43] *Swaps and Derivative Financing*, Satyajit Das, 2nd ed. (Irwin, 1994), 113 *et seq.*.
[44] Where the transaction is particularly complex.
[45] *Swaps and Derivative Financing*, Satyajit Das, 2nd ed. (Irwin, 1994), 119.

Capital markets arbitrage

The second mechanism for pricing swaps is the use of capital market arbitrage calculations. Given that the use of swaps is often to arbitrage the funding possibilities between different financial markets, the comparative costs of transacting in different markets is an important factor in pricing these products.[46] Given the anomalies which markets generate, there will always be scope for arbitrage. Tax regulation, capital adequacy regulation and other general financial regulation impact on the transaction costs of swaps. Similarly, perceptions of risk attached to particular markets will impact on pricing decisions. Volatile markets attract higher prices in accordance with the return required to offset the increased risk that is taken. The term 'markets' in this context can refer to geographic markets, to particular financial sectors, or a specific form of index or exchange. Added to this is the perception of any particular market participant within such market. As considered above, perception of credit worth and cost of funding may be have an effect on the value of the derivative and therefore on the pricing of a derivative in respect of a specific counterparty.

An example of swap arbitrage would occur in the following circumstances. Suppose that A plc can borrow floating rate loan funding at LIBOR and fixed rate bond funding at 6%. Similarly, B plc can borrow floating rate loan funding at LIBOR + 100bp and fixed rate bond funding at 7%. There is therefore a respective difference in funding cost of 100bp and 1% respectively: there is clearly a large differential between these differences which are not untypical in capital markets. A wishes to pay a floating rate but can only pay a fixed rate to bond investors. B wishes to pay a lower floating rate than it is able to obtain in the market. A structured, capital arbitrage solution would operate as follows.[47]

The parties would then borrow in the markets which best suit them and swap their respective borrowings through an intermediary bank. The cost to A of paying 6% to the bond market can be swapped for the floating rate A wishes to pay for its debt (LIBOR). The fixed rate paid to the bond investors can be obtained from B where B pays a floating rate (via the intermediary bank) and receives A's floating rate of funding (LIBOR) which it passes to its own lenders. As a result, A pays its preferred floating rate interest and receives a higher rate from B. B has a comparatively high debt cost; A has a much lower debt cost. B prefers to pay A's debt cost. B in turn receives a floating rate which matches much of its obligations to its own lenders, thus reducing its own effective cost of funding.

On a net basis, both parties are closer to their preferred cost of funding than is possible in the marketplace in which it is commercially required to borrow. The role of the intermediary bank would have been to bring these two parties together and set up parallel transactions. In the swaps cases which make up the bulk of this book, intermediary investment banks brought together lending institutions and the local authorities who needed either debt funding or debt management (or both). In the modern marketplace the intermediary would not necessarily need to introduce the parties but might take the risk of both transactions by 'warehousing' both sides of the deal and

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[46] *Swaps and Derivative Financing*, Satyajit Das, 2nd ed. (Irwin, 1994), 126 *et seq.*.

[47] This example draws on a more complex worked hypothetical situation suggested by Das, op cit, 131-133.

setting the separate deals off in its own swap book.[48] These arbitrage considerations are then priced into the transaction.

The core importance of the 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.

As considered in the remainder of this paper, the English courts have sought to analyse each swap contract as a distinct legal entity which is separate from all of the other contracts entered into between those parties and the hedging transactions which are contracted as a direct consequence of them. This fits into the neat English law model which demands direct connections between contracts for losses caused by one to be capable of account in respect of another. However, it also constitutes a blindness as to both the actual functioning of financial markets and, more significantly, the necessarily prudent functioning and risk management capabilities of those same relationships.

The Future

[48] This reluctance to introduce the parties to one another might arise in the situation of a house bank jealous of its proximate status to the client but reluctant to assume any more lending exposure to the counterparty.

Whereas the foregoing discussion of swap pricing models involves a great deal of complex mathematics in its application, the building blocks of the analysis are not complicated. The core of any derivatives pricing structure is that it looks at the component parts of the transaction rather than at the totality of the transaction.

The growth of new markets has introduced some new strands to the analysis of the financial derivative. Foremost among the developments is the 'credit derivative'. At the time of writing the credit derivative is a novel form of open market instrument which has yet to have a standard form market contract developed for it[49] and market participants are only beginning to explore the regulatory, legal and accounting issues which surround these products.[50] The theory behind the credit derivative is that it is priced according to the credit worth of a 'reference entity', rather than according to a fixed or floating rate market indicator. The aim of the credit derivative is to provide a means of hedging exposure to the credit worth of a particular entity or market sector. The seller of the derivative agrees to pay a cash flow to the buyer. The buyer is obliged to make reciprocal payment, usually, in the event that the credit worth of the reference entity deteriorates.

The aim of the credit derivative is to provide a means for investors in, for example, the publicly issued debt of a particular reference entity, to hedge their exposure to that entity failing to pay by selling credit derivatives. Alternatively, the credit derivative provides investors the ability to speculate on the credit worth of particular reference entities or on a particular market sector. The investor receives a return which is priced according to the credit worth of the reference entity. The calculation of this credit worth factor generates the mathematical complication and is dependent upon the type of structure used.

The structure can operate in a number of ways. First, the parties could agree to a swap structure in which seller pays a fixed rate and buyer pays a floating rate. The floating rate will be close to zero unless the reference entity's credit worth deteriorates. Second, the parties could structure the agreement as an option where seller pays a lump sum premium (possibly in instalments) and thus buys the option to receive a cash sum from the buyer calculated in accordance with the credit worth of the reference entity.

The credit swap takes two forms. The first is the 'total return swap' under which the total return of a bank loan or credit-sensitive is exchanged for a fixed rate cash flow or, more usually, a floating rate cash flow linked to an indicator such as LIBOR. Typically there will not be any exchange of principal amounts or change of ownership of any assets. Some commentators consider this structure to be a form of synthetic security or synthetic loan in that it achieves the same cash flow effect as a security or loan by means of the swap structure.[51] A total return swap will be cash settled.

The alternative formulation is the 'default swap' under which a premium, lump sum payment is swapped for an amount contingent on a specified credit event where the size

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[49] ISDA published a draft Credit Derivatives confirmation in November 1997 but this has yet to be widely used and was not in a completed form at time of writing.
[50] See 'An Introduction to the Legal Accounting and Control Challenges of Credit Derivatives', chaired by Hudson, London, 8th December 1997 (materials IBC, 1997).
[51] See Whittaker and Kumar, 'Credit Derivatives - A Primer', *Derivative Instruments*, revised edition., ed. Konoshi & Dattatreya (Irwin, 1996), 595 *et seq*.

of that floating amount is calculated by reference to that credit event. Default swaps are created in connection with a single reference entity or a range of reference entities. The forms of credit event will span a spectrum from bankruptcy and events close to insolvency, to cross default by associated entities or cross acceleration of other forms of public or private debt. In many cases reference is made to downgrading by credit ratings agencies or the performance of specified financial criteria such as gearing or interest coverage. The default payment is therefore linked to a specific performance on an underlying security or loan. Some commentators describe this as a 'binary pay-off'.[52]

Option or forward structures are orientated around a number of types of 'credit-linked note' in which financial institutions have tended to assert their copyright. The notes aim to link the return on the note to the credit-related performance of the underlying security or loan. There is therefore a bi-cameral means of calculating the value of the security: first, the performance of the issuer and, second, the credit performance of the underlyer and the redemption value of that underlyer. A credit option gives the buyer the ability to buy an asset which is linked to performance of the underlyer. The result of using either product is to create a sophisticated hedging position linked to the credit performance of the underlying asset or liability.

The underlying pricing structure is the same as for a vanilla option or swap. Each payment is considered separately and priced according to its status as a forward or swap. Into this pricing mechanism is a factor to account for the credit worth of the reference entity and its associated volatility. There is no difference from a vanilla product in pricing in such a factor to account for credit worth. However, the value of that factor may differ given the centrality of the credit worth element to the transaction.

The credit derivative is a complex market instrument which contains enormous mathematical complication, above and beyond vanilla products. There are issues surrounding its proximity to a contract of insurance, given that it is an obligation to make a payment in the event that a given risk produces a given financial exposure. The appropriate categorisation for the credit derivative for regulatory capital purposes is similarly complicated. It is not clear whether or not the credit derivative ought to receive a capital weighting equivalent to an equity, debt or commodity product. Despite that complication the core analysis remains the same: the product is priced according to is constituent segments and not its totality.

One further point is made as to 'tax derivatives' - a novel form of derivative which seeks to arbitrage differences in tax regulations either between jurisdictions or different forms of transaction within a single tax jurisdiction. The tax derivative is rarely considered as a stand-alone form of product because it is usually transacted as one of the products already discussed but with a commercial purpose which is orientated around tax avoidance. It is submitted that, further to the preceding point that a financial derivative is properly analysed according to the way in which it is created and priced (that is by reference to its constituent segments), any court presented with a tax derivative would

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[52] See the discussion of binary options above for an example of binary payments. Commentators include Whittaker and Kumar, 'Credit Derivatives - A Primer', *Derivative Instruments*, revised edition., ed. Konoshi & Dattatreya (Irwin, 1996), 595 *et seq*.

look to its substance as a series of segments rather than at the tax efficient form of its totality.

For example, where a series of payments for goods or services generate a liability to tax on each occasion that such payment is made, the tax efficient solution would be to tie those payments up into one single, larger contract which provided that no payment obligation was to be treated as expired unless all payments were made. This would be a series of forwards or options packaged as a single swap. The commercial aim would be to delay the liability to tax until the end of the contract.[53] Applying the principle in *Furniss v. Dawson* it is contended that the court would look at such a repackaging of a commercial transaction and consider it to contain an artificial step or as a structure which is properly analysed in accordance with its structure as a series of individual forwards or options rather than an executory contract. Therefore, while many analysts favour the single, executory contract approach, it is contended that the pragmatic view of the courts ought to be to look to the substance of its pricing and payments rather than to its contractual form.

Availability of proprietary remedies

The central contention of this [work] is that the result of the majority decisions in the House of Lords in the swaps cases is that it impossible for parties to retain a proprietary interest in property transferred either under a commercial contract which is found to be void *ab initio* or any credit support provision in a collateral agreement. The restatement of the core rules of equity in the speech of Lord Browne-Wilkinson in *Islington* created a test that a proprietary claim based on a constructive trust will only be imposed in circumstances where the defendant has knowledge of the factor which is alleged to impose the office of trustee on him, thus affecting his conscience. Similarly, a proprietary claim based on resulting trust will only obtain where a purported express trust of an equitable interest has failed to allocate the whole of that interest, or where an equitable interest is created by dint of contribution to the purchase price of property. It is submitted that these principles restrict the potential intervention of equity to such a narrow range of cases that the mutual intentions of parties to commercial contracts will frequently not be enforced by either the rules of common law or of equity.

The swaps cases concerned two forms of interest rate swap. The first was a deep discount swap in which a lump sum was paid by the bank to the local authority, as well as the usual payment of fixed and floating rate amounts between the parties, calculated by reference to a notional amount of money. The second was a vanilla interest rate swap providing for payments of fixed and floating amounts of interest, calculated by reference to a notional amount of money. Further to the decision of the House of Lords in *Hazell v. Hammersmith & Fulham*,[54] these contracts were held to be ultra vires the local authorities and therefore void ab initio. The issue arose as to

[53] Some tax structures using 'perpetual stock instruments' sought to use single, executory contracts which would never expire, thus purportedly never generating a charge to tax. The Special Commissioners have held that such a structure will be effective where there is a genuine commercial purpose in the transaction.
[54] [1992] 2 A.C. 1.

manner in which the banks were entitled to seek recovery of sums paid to the local authorities.

The House of Lords was unanimous in holding that neither the lump sum nor any of the interest amounts were to be held on resulting trust. Further, it was unanimous in holding that there would not be constructive trust imposed over the money on the basis that the local authorities did not know that the money had been advanced to them under a void transaction and therefore their consciences had not been affected. At most there was a personal claim in restitution for the amount of money transferred under the void agreement together with simple interest. 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.

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

Managing legal risk

There are two primary considerations for lawyers in creating financial market transactions: the ability to set-off on insolvency of the counterparty and the general efficacy of termination provisions. This article considers the growth of recent caselaw in this area and the impact of recent House of Lords decisions on the efficacy of financial contracts. Of particular interest is the impact of the swaps cases *Westdeutsche Landesbank v. Islington*[55] and *Kleinwort Benson v. Glasgow City Council*[56] on the contractual and restitutionary effect of void contracts, and the decisions in *Morris v. Rayner Entreprises Inc.*[57] and *Re Bank of Credit and Commerce International SA (No.8)*[58] on the availability of set-off in case of insolvency. Each is considered in turn.

In the recent decision of the House of Lords in *Morris v. Rayner Entreprises Inc.*[59], Lord Hoffmann, delivering the only speech, sought to uphold commercial practice where it does not offend against public policy. Rather 'the law is fashioned to suit the practicalities of life and legal concepts like 'proprietary interest' and 'charge' are no more labels given to clusters of related and self-consistent rules of law.' In the context of financial derivatives, the decisions in the swaps cases have led to the overturning of the legal efficacy of a number of established, prudent market practices set out in standard documentation. The availability of netting of obligations and the organisation of proprietary rights in property by means of contract and credit support documentation.

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[55] [1996] A.C. 669.
[56] [1997] 4 All E.R. 641.
[57] 30th October 1997 (unreported).
[58] [1997] 4 All E.R. 568.
[59] 30th October 1997 (unreported).

The Legal Context of Money

Central to the issue of deciding the swaps cases is the issue of the property which was involved in those cases. Earlier the distinction was drawn between cash-settled and physically-settled transactions. In the decided cases there was no issue of delivery of physical assets. The only situation in which delivery of specific property was an issue was in the deep discount swap cases where the extension of the original 'loan' amount was essential.[60] As considered below, the resolution of the disputes by the English courts in these cases fail to appreciate the nature of the performance of the transactions and the intangibility of the property involved.

What is 'money'?

The definition of 'money' is a perennial problem for the lawyer. Indeed it is one that is so intrinsic to many legal conundra that it is rarely addressed explicitly at all. As set out in F.A. Mann's exhaustive '*The Legal Aspect of Money*'[61], there is a real problem with achieving a comprehensive legal definition of the term. The term 'money' as used by economists and by bankers is equally difficult to pin-point. In the mind of the derivatives professional, money divides between physical foreign exchange and "cash value equivalent". The notion of 'value' is perhaps closer to money in this context. It is unusual for there to be real physical settlement of cash in financial transactions. Even at the level of currency swaps, it is usually an electronic transfer of amounts of a specific currency (whose value is calculated by reference to some market indicator) which takes place, rather than the re-allocation of notes and coins. There is clearly a considerable amount of retail foreign currency business which is contracted through high street clearing banks but this is small beer compared to the money markets transactions and foreign exchange transactions which typically take place between financial institutions and the treasury departments of their corporate clients.

The use of electronic funds transfer is the re-allocation of debts - that is, value held in electronic bank accounts is assigned to other accounts. There is no physical settlement in the sense that is understood by the transfer of tangible chattels like sales of paintings at auction. The delivery of physically settled transactions in the foreign currency field (the for-ex markets) takes place at a virtual level: that is, no physical property ever exists nor is any transferred. Rather, amounts of value represented by electronic bank accounts are transferred. While there is generally an entitlement to claim delivery of notes and coins in respect of the value held in a bank account, it is rare for such delivery to take place.

Globalised capitalism operates at the level of the transfer of "equivalent value". It also operates at the level of arbitrage between different measurement mechanisms. An amount of sterling held in a bank account will have its market value altered from day-

[60] As set out with reference to the *Islington* litigation below.
[61] F.A. Mann '*The Legal Aspect of Money*', 5th edn. (Oxford, 1992).

to-day, minute-to-minute as the value of sterling fluctuates in the marketplace. Sterling's market value will change according both to its value compared to competitor currencies and in relation to the interest rate which attaches to deposits of sterling in the money markets.

Mann seeks to achieve a legal definition of 'money'. His definition is:-

> '… the quality of money is to be attributed to all chattels which, issued by the authority of the law and denominated with reference to a unit of account, are meant to serve as universal means of exchange in the State of issue.'[62]

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

Goode describes money as fungible in that any unit of account is capable of being exchanged for any other unit of account.[63] However, the issue remains that it does have to be segregated for trust or for tracing purposes before any proprietary claim can be established.[64] Thus, where a bank account goes overdrawn, the money that was held in that bank account is said to disappear.[65] This turns against the assertion made by Goode, that the nature of money is such that it ought not to matter which part of the fund is allocated subject to the proprietary base required to found an equitable tracing claim. The Court of Appeal has accepted that where a fund of identical units is impressed with a trust equal to 5% of their total value, there is no requirement to segregate out a fund equal to that 5%.[66] This decision, is however, in opposition to the speech of Lord Browne-Wilkinson in *Islington*[67] and the speech of Lord Mustill in *Re Goldcorp*.[68] As such there is a fundamental difficulty with deciding whether or not money is a form of property which, at English law, is required to be segregated in order for there to be a binding trust over it. Without the possibility of a binding trust, the efficacy of standard market means of taking security is negated.

The difficulty caused by these analyses of money, as Millett J. held in *Agip v. Jackson*,[69] is that it is impossible to maintain an action for tracing at common law where money was moved between accounts by means of 'telegraphic transfer'.[70] His lordship held that the property which was being dealt with in *Agip* was really a transmission of electrons between computers which evidenced debts of money in the form of bank accounts. Similarly, the issues before the House of Lords in *Westdeutsche Landesbank v. Islington* were concerned with the payment, and sought-after repayment, of amounts of money represented by electronic bank accounts and

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[62] F.A. Mann '*The Legal Aspect of Money*', 5th edn. (Oxford, 1992), 8.
[63] Goode, Commercial Law 2nd edn. (Penguin,), 491.
[64] *Re Goldcorp* [1995] 1 AC 74; *Boscawen v. Bajwa* [1996] 1 WLR 328.
[65] *Boscawen v. Bajwa* [1996] 1 WLR 328; *Roscoe v. Winder* [1915] 1 Ch. 62.
[66] *Hunter v. Moss* [1994] 1 WLR 452.
[67] [1996] AC 669.
[68] [1995] 1 AC 74.
[69] [1990] Ch 265; affirmed at [1992] 4 All E.R. 385.
[70] [1990] Ch 265, 279.

telegraphic transfers. Indeed Lord Goff makes the following point early in his judgement:-

> '… the basic question is whether the law can restore the parties to the position there were in before they entered into the transaction. I feel bound to say that, in the present case, *there ought to be no difficulty about that at all. This is because the case is concerned solely with money. All that has to be done is to order that each party should pay back the money that it has received* - or more sensibly strike a balance, and order that the party who has received most should repay the balance; and then to make an appropriate order for interest in respect of that balance. It should be as simple as that. And yet we find ourselves faced with a mass of difficult problems, and struggling to reconcile a number of difficult cases.'[71] [author's emphasis]

It is as though the practical problem is so straightforward ('pay back the money') and yet a number of issues of legal analysis arise concerning the proprietary and personal nature of the remedies, and the applicable codes of rules under which they should be awarded. Nothing but a stream of electrons passes between the banks as a result of telegraphic transfers.[72] The very nature of inter-bank clearing systems creates problems of identifying property.[73] The broader issues of property law involved in money laundering and tracing property in money is created by the very intangibility of the property involved.[74] The issue also arises: what constitutes a proprietary claim with respect to this type of property? Having the use of the property would connote an ability to earn compound interest on it. It is submitted that to arrive at any other measure of the proprietary rights attached to money would be too speculative because it is impossible to know how the money would have been invested if it had not been applied to the transaction between the bank and the local authority. In the context of financial contracts, compound interest is the appropriate measure of proprietary title. Therefore, the approaches of Lord Goff and Lord Woolf to award compound interest while expressly disavowing proprietary claims in *Islington*[75] appear to be counter-intuitive because the award would have been tantamount to a proprietary remedy.

It is in the House of Lords that much of the legalistic, as opposed to Lord Goff's common sense, problems with the case arise. Lord Browne-Wilkinson is not able to begin his analysis at the place where Millett J in *Agip* places the modern performance of financial contracts by electronic transfer. Rather, there is a need to retreat into the history of money as a chattel - where the intrinsic worth of coins were equal to their face value. This requires Lord Browne-Wilkinson to begin with the analysis of the title to a stolen bag of coins, before progressing to consider the applicability of equitable tracing rules to deep discount and income payments made in *Islington*.[76]

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[71] [1996] 2 All E.R. 961, 966.
[72] *Agip v. Jackson* [1990] Ch 265, 286, *per* Millett J.; CA [1991] Ch 547.
[73] (1995) 54 CLJ 377 (A. Oakley).
[74] Birks (1989) 105 LQR 258; Millett (1991) 107 LQR 71; 50 CLJ 409 (C. Harpum); [1992] Conv. 367 (S. Goulding); All ER Rev. 259 (Swadling).
[75] See below.
[76] As Dworkin puts it in 'A Matter of Principle' where those who want money are fetishists after 'little green paper'. See Elias, *Explaining Constructive Trusts* (Oxford,), 25. Even this analysis presumes that there is cash.

This inability to conceive of money as being really just value represented by electronic bank accounts is an enormous source of encouragement to money-launderers. Given that the common law will not allow tracing beyond clean substitutions[77] and that equity will not permit tracing after money where the bank account where it was held has subsequently gone overdrawn,[78] laundering money becomes seemingly straightforward. The impact of the *Homan* decision is that even bank accounts are still to be treated as containing chattels which cease to exist once they have moved out of that account. The more enlightened comments of Lord Templeman, obiter, in the *Space Investments* case[79] have been much derided. His lordship commented, in terms, that money should be seen as value which augments the value belonging to its recipient even if it cannot be identified as a specific item of property taken from the original owner. This 'swollen assets' approach is the orthodoxy in US legal systems less addicted to property rules. The need to see property rights relating to a specific 'thing', is at odds with the operation which tracing aims to perform of identifying 'value' in respect of which rights can be enforced. This returns to the straightforward jurisprudential argument between property law as consisting in either rights in the thing or rights against other people.[80]

The availability of proprietary remedies

The issue also arises: what constitutes a proprietary claim with respect to this type of intangible, virtual property? Having the use of value in an electronic account was accepted in *Islington* as connoting an ability to earn compound interest on it.[81] In the context of financial contracts, compound interest is the appropriate measure of proprietary title. Therefore, the approaches of Lord Goff and Lord Woolf in *Islington* to award compound interest while expressly disavowing proprietary claims for the bank appear to be counter-intuitive where that award would have been tantamount to a proprietary remedy in any event.

The restatement of the core rules of equity in the leading speech of Lord Browne-Wilkinson in *Westdeutsche Landesbank v. Islington* created a test that a proprietary claim in constructive trust will only be imposed in circumstances where the defendant has knowledge of the factor which is alleged to impose the office of trustee on him, thus affecting his conscience. Similarly, a proprietary claim based on resulting trust will only obtain where a purported express trust of an equitable interest has failed to allocate the whole of that interest, or where an equitable interest is created by dint of contribution to the purchase price of property. It is submitted that these principles restrict the potential intervention of equity to such a narrow range of cases that the mutual intentions of parties to commercial contracts will frequently not be enforced by either the rules of common law or of equity.

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[77] *Jones v. Jones* [1996] 3 WLR 703.
[78] *Bishopsgate v. Homan* [1995] Ch 211.
[79] [1986] 1 WLR 1072, 1074.
[80] See Eleftheriadis, 'The Analysis of Property Rights' (1996) 16 OJLS 31.
[81] It is submitted that to arrive at any other measure of the proprietary rights attached to money would be too speculative in any event.

The House of Lords was unanimous in holding that neither the lump sum nor any of the interest amounts were to be held on resulting trust. Further, it was unanimous in holding that there would not be constructive trust imposed over the money on the basis that the local authorities did not know that the money had been advanced to them under a void transaction and therefore their consciences had not been affected. At most there was a personal claim in restitution for the amount of money transferred under the void agreement together with simple interest.[82]

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

Prof Birks refers to their being no real difference between Lords Goff and Browne-Wilkinson in the interpretation of the equitable and restitutionary techniques available in *Westdeutsche Landesbank*.[83] Birks is somewhat dismissive of the extent of any change that is introduced by Lord Browne-Wilkinson.[84]

The availability of equitable proprietary remedies

Lord Browne-Wilkinson held that there could be no retention of any rights in the deep discount payment by the bank because both parties intended that there be an outright transfer of that sum to the authority. The argument for the imposition of a resulting trust would be that there was no intention to make a voluntary and outright transfer of the property in circumstances where the contract is found to be void ab initio.[85] The radical restitutionary approach, typified by the work of Prof. Birks in seeking to understand the core rationale for effecting restitution to be a remedy for unjust enrichment by subtraction of that enrichment, is considered expressly by their lordships. For the most part the radical approach fairs badly before the House of Lords. Prof. Birks suggests that the role of the resulting trust is primarily restitutionary and that this form of resulting trust should be imposed in cases of mistaken payment or failure of consideration to reverse unjust enrichment.[86] At the root of both arguments in favour of the use of the resulting trust is the assertion that the most appropriate response is to hold that the equitable interest in the property in question is to be deemed to have remained with the payer - whether that assertion is based on equitable or restitutionary conceptions of justice.

[82] 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.
[83] [1996] RLR 3.
[84] [1996] RLR 3.
[85] In this regard, see Worthington '*Proprietary Interests in Commercial Transactions*' (Oxford, 1996), xi.
[86] See Birks, 'Restitution and Resulting trusts ' in S. Goldstein, (ed.), *Equity and Contemporary Legal Problems* (1992), 335.

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

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

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

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

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

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

The issue which arises is: how can a void contract be given effect to in part? More specifically, if the swap contract is held to have been void ab initio, how can the termination provisions or retention of title clauses be effective still. There are two arguments on this basis. First, it is clear from *Re Goldcorp*[87] that if a contract is avoided by election of the parties, and property transferred under that contract can still be identified, a constructive trust will be imposed over that identifiable property. Therefore, there is a difference between the enforceability of a voidable contract and a void contract as a result of *Islington*.[88]

Second, it is submitted that it would be possible to sever the termination provisions from the economic provisions of the swap contract, as considered above. The risk management features of standard market financial documents introduce greater certainty and lessen the cash amounts required to be paid between market participants. Therefore, the identified policy of precluding the parties from entering into further damaging transactions does not apply in the context of a provision, such as a netting clause on termination, which reduces the net amount of the parties' exposure to one another. The validity of an instrument need not be compromised because some element of it is held to unenforceable.[89]

Effectiveness of the standard form contracts

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

The problem with the decision in *Islington* and all of the other swaps cases is that the courts ignore the *fact* that the parties *had allocated the risks of their transactions*. Leggatt LJ considered that there was no substantive issue to consider on the facts of *Islington*, rather 'the parties believed that they were making an interest rate swaps contract. They were not, because such a contract was ultra vires the local authority. So that they made no contract at all.'[90] Therefore, despite the exhaustive documentation created between the parties, the courts made no reference at all to any of the

[87] [1995] AC 74; also Worthington , *supra*..
[88] It is accepted that in *Islington* the property was no longer identifiable because the bank account into which the property had been paid had subsequently been run overdrawn on a number of occasions.
[89] *Gaskell v. King* (1809) 11 East. 165; *Gibbons v. Harper* (1831) 2 B. & Ad. 734.
[90] [1994] 4 All E.R. 890, 967.

contractual terms agreed between them. Precisely why there was no such reference is not made clear. At one level it would appear that no argument was raised by counsel as to the efficacy of the risk allocation provisions.

The terms of the contracts were considered to have been of no relevance because the authorities were held not to have been capable of entering into them at all in any event. As a result, it must be surmised in the absence of any express findings, it was considered appropriate to ignore any term within that contract on the basis that it had been found to be void. Logically this would include terms dealing with credit risk management, as well as terms dealing with the creation of commercial interest rate swap obligations.[91] No point was raised that set-off provisions were ultra vires the local authorities - simply that contracts establishing obligations to make interest rate swap payments were.

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

If that were the case, it would follow that any credit support document or set-off provision attached to the interest rate swap agreement would be similarly void. Therefore, if the authorities had ring-fenced a particular bank account with an amount of money in it, held on a trust (within the terms of the swaps contract) for the banks contingent on the authorities' failure to perform under the main agreement, the banks would have had no recourse to that money. This would be despite the authorities' ability to pay amounts of money to banks acting at arm's length from them by way of interest or fees.

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

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

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

[91] On this, see *Suitability Approach,'Severance'* below.

> 'After all, [Westdeutsche] has entered into a commercial transaction, and so taken the risk of the defendant's insolvency, just like the defendant's other creditors who have contracted with it, not to mention other creditors to whom the defendant may be liable to pay damages in tort.'[92]

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

The 'swaps cases' concerned two forms of interest rate swap. The first was a deep discount swap in which a lump sum was paid by the bank to the local authority, as well as the usual payment of fixed and floating rate amounts between the parties, calculated by reference to a notional amount of money. The second was a vanilla interest rate swap providing for payments of fixed and floating amounts of interest, calculated by reference to a notional amount of money. Further to the decision of the House of Lords in *Hazell v. Hammersmith & Fulham*,[93] these contracts were held to be ultra vires the local authorities and therefore void ab initio. The issue arose as to manner in which the banks were entitled to seek recovery of sums paid to the local authorities.

There is only one route left available to them. With reference first to the deep discount swaps, that route would have been for the banks to hold the deep discount amounts[94] paid by them on trust for themselves should the authority fail to perform. The authorities' ability to use the money to massage their rate-capped income position (the commercial purpose for the swap) would have been made complicated. It is difficult to see how there could have been retention of title where the contracts which would have contained that language were held to be void.

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

At the time when the intention to pass title in the money to the authority was formed, the issue arises what risks were accepted and appropriated between the parties.

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[92] [1996] 2 All E.R. 961, 968.
[93] [1992] 2 A.C. 1.
[94] In *Islington*.

Avowedly, neither party took an unallocated risk that the other party would be unable to perform the agreement (as set out in the BBAIRS and ISDA terms above). However, their agreement provided only for the payment of net amount to unwind the transaction and did not provide for any specific retention of proprietary title in the property passed. Therefore, it is not proposed to consider the impact of the *Quistclose*[95] line of cases because there was no express retention of title as in those cases.

With reference to the vanilla interest rate swaps,[96] it would be simply impracticable to require that payments made under the periodic structure would be held on trust through the life of the agreement. The property forming the subject matter of that trust, value in electronic bank accounts, would be exhausted a number of times over thus removing all equitable tracing rights. To require a static trust would again defeat the parties' commercial purpose because the interest rate swap would be of no commercial efficacy at all. The use of language to create some charge over the property of the authority would similarly be void, annexed as it would be to the void interest rate swap contract.

Therefore, the practical commercial implications of the decision of the House of Lords is that it is impossible to retain title to any property or value passed in the conduct of a swap transaction which is subsequently found to be void. This result must indicate that the rationale behind the decision cannot be the correct approach in commercial contexts. While it might be the better approach with reference to domestic mortgages, it is not appropriate with reference to sophisticated financial transactions.

Martin joins the camp of commentators who identify in the bank satisfaction that they would pass title in the deep discount payment absolutely to Islington 'and had been prepared to take the risk of insolvency'.[97] There was, of course, no intention to take that risk absent effective netting provisions. The result is that property in the money passes even though the contract is void. This efficacy of the contract would appear to be in support of the original purpose of the contract, rather than returning the full property in the money to the bank to negate the commercial effect of the transaction.

Severance

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

The classic statement of the doctrine of severance is that: 'where you cannot sever the illegal from the legal part of a covenant, the contract is altogether void; but, where you

95 *Quistclose Investments Ltd v. Rolls Razor Ltd (in liquidation)* [1970] AC 567.
96 In *Sandwell*.
97 Hanbury and Martin 'Modern Equity' (13th edition, Sweet & Maxwell, 1993), p.665.

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.'[98]

The decision of Megarry J. in *Spector v. Ageda* [99] held that the whole of the contract must be considered to be void even where a part only of the agreement had been found to be illegal by operation of statute. The policy identified in this decision was to prevent parties to illegal contracts from putting themselves into further harm by enforcing other contracts. Similarly, in *Esso Petroleum v. Harper's Garage (Stourport) Ltd.* [100] it was held that where covenants in a contract are so closely connected that they can be deemed to stand or fall together, the whole contract will fail even though some sections may appear to be severable.

The doctrine of severance might also apply with reference to the distinction between executed and non-executed transactions. It could be submitted that, where the parties have acted consensually, and without any other unjust factor such as fraud or undue influence, there is no injustice in requiring the parties to observe their agreement.[101]

In the Court of Appeal in *Islington*, Dillon LJ held, considering *Rugg v. Minett*[102]

> 'I do not see why a similar process of severance should not be applied where what has happened, in a purely financial matter, is that there has been a payment of money one way and a payment of smaller sums of money the other way. The effect of severance is that there has been a total failure of consideration in respect of the balance of the money which has not come back.'[103]

One important issue arising in this context is why severance had not been similarly available with reference to the *Sandwell* litigation[104] where some of the contracts had been performed. The further issue is whether some of the payments made between the parties could be treated as settled (thus supporting a mutual debts analysis) or whether they are to be required as part of a single (executory) contract which had not been fully performed until the final payment had been made.[105]

The argument from risk

[98] *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.
[99] [1973] Ch 30.
[100] [1968] A.C. 269, 314, 321.
[101] There is a further issue as to the efficacy of collateral 'credit support agreements' which cannot be considered here due to lack of space. However, it appears that ISDA's current strategy with regard to credit support documentation will not be sustainable in the light of the decisions in *Islington* and *Kleinwort Benson v. Glasgow C.C.*.
[102] [1994] 4 All E.R. 890, 960.
[103] [1994] 4 All E.R. 890, 961.
[104] The joined appeal with *Islington* at first instance: [1994] 4 All E.R. 890.
[105] On this issue see *Amicus Curiae* , November 1997, Vol. 2, p.27.

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

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

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

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

The market place has sought to introduce some protection against this form of total market risk by standardising market practices and standardising legal documentation. The work of ISDA and of the BBA, among others, has been to ensure that termination provisions, payment systems and netting provisions are both standardised and legally effective.[106] This is the source of the derivatives market's particular concern about the decisions affecting local authorities. At one level, the finding in *Hazell* that local authorities were not capable to enter into interest rate swaps caused concern with reference to deals with local authorities. However, the greater disquiet has been caused by the manner in which English law has both failed to enforce the terms of those standard market contracts and the denial of proprietary remedies to market participants.

Allocation of risks in derivatives documentation

Much has been said in the introductory argument about the determination of the English courts in the swaps cases to refuse to consider the terms of the contracts entered into between the parties.[107] The core argument asserts that arguments based on risk allocation and suitability of product should not be dismissed because they are based on void contracts. As submitted above, the calculation of risk and the structuring of financial products to meet those risks are the foundations of the creation of financial derivatives. Furthermore, the attitude of the courts would appear to make it impossible to effect credit support for such transactions in circumstances where they are held to be founded on unenforceable contracts. It is contended below that it would be possible to adapt either equitable or restitutionary principles to give effect to the common intention of the parties.

The markets attempt to allocate risks generally by means of standard form documentation. In all cases, such documents are predicated on the basis that the parties can enter into the transactions which they purport to effect. The BBAIRS agreement (British Bankers Association Interest Rate Swap standard terms)[108] provides as follows:-

> 1. "Representations and Warranties
>
> 1.1 Each party represents and warrants to other that:-
>
> i) it has full power and authority (corporate and otherwise) to enter into this Agreement and to exercise its rights and perform its obligations hereunder and has obtained all authorisations and consents necessary for it so to enter, exercise rights and perform obligations and such authorisations and consents are in full force and effect;
> ii) the obligations expressed to be assumed by it under this Agreement are legal and valid obligations binding on it in accordance with their terms …

[106] The details of these forms of contract are analysed in Hudson, *The Law of Financial Derivatives* (Sweet & Maxwell, 1996).
[107] This discussion is amplified below in *Problems of Credit and Security*.
[108] Published by the BBA.

5. Events of Default

The occurrence of any one or more of the following circumstances in respect of either party … shall be an Event of Default:

i) failure by the Defaulting Party to pay any sum due and payable hereunder within three Business Days of receipt of written notice from the other party … that such sum is overdue; or

iv) any representation made or warranty given by the Defaulting Party pursuant to Clause 1 is or proves to have been materially incorrect or misleading when made."

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

It should noted that the BBAIRS terms were intended to be a default market standard agreement for market participants operating on the London interbank market.[109]

The ISDA (International Swaps and Derivatives Association) 1992 edition of the Multicurrency Master Agreement[110], provides:-

1. Interpretation

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

3. Representations

(a) Basic Representations

(i) Status. It is duly organised and validly existing under the laws of the jurisdiction of its organisation or incorporation and, if relevant under such laws, in good standing;

[109] "5. … With effect from 2nd September 1985 … in the absence of clarification to the contrary, banks and brokers in the London interbank market will be assumed to be operating on BBAIRS terms for swaps of less than 2 years maturity within the defined categories."
[110] Published by ISDA.

(ii) Powers. It has the power to execute this Agreement and any other documentation relating to this Agreement[111] to which it is a party, to deliver this Agreement and any other documentation relating to this Agreement that it is required by this Agreement to deliver and to perform its obligations under this Agreement and any obligations it has under any Credit Support Document to which it is a party and has taken all necessary action to authorise such execution, delivery and performance;

(iii) No Violation or Conflict. Such execution, delivery and performance do not violate or conflict with any law applicable to it, any provision of its constitutional documents, any order or judgement of any court or other agency of government applicable to it or any of its assets or any contractual restriction binding on or affecting it or any of its assets;

(iv) Consents. All governmental and other consents that are required to have been obtained by it with respect to this Agreement or any Credit Support Document to which it is a party have been obtained and are in full force and effect and all conditions of any such consents have been complied with; and

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

5. Events of Default and Termination Events

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

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

In the event of such early termination, the non-defaulting party (on giving the necessary notice and allowing for any applicable grace period) is entitled to nominate a date on which the Agreement is to terminate. On that date, a single termination amount is to be calculated. That amount is a net amount representing the net position between the parties calculated either as the replacement cost of the terminated transactions[112] or with by reference to the loss suffered by the non-defaulting party. 'Loss' in this context expressly includes a good faith estimate of 'losses and costs …

[111] This would include the Credit Support documentation set out later in the Agreement and required to be specified precisely in the Schedule to the Agreement.

[112] Such values are calculated by reference to quotations from nominated market makers in those transactions.

including any loss of bargain, cost of funding … loss or cost incurred as a result of its terminating, liquidating, obtaining or reestablishing any hedge or related trading position'.[113] Also captured within the definition of 'loss' are any costs associated with delivery of goods under physically-settled transactions.

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

Where an over-the-counter market is under pressure from regulators and legislators as to the future treatment of the market,[114] and increased concerns about the safety of the markets and of investors in the wake of the Barings and the Orange County affairs, the denial of efficacy to market-based initiatives for the standardisation and risk management of derivatives products by the English courts is an unfortunate development.

Conclusion

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

It is suggested that the usual defences of change of position and passing on would still obtain. Similarly, public policy would constitute an exception in such circumstances. A remedy by means of equitable compensation or by imposition of personal liability under constructive trust should be made available in cases of reckless risk-taking; or where the product was unsuitable; or if rescission is the appropriate remedy under a cash-settled transaction[115]; or if the risk taken, or the context in which the risk was taken, contravened some principle of public policy or of statute or of some other mandatory rule of law or equity.

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[113] ISDA Multicurrency Master Agreement, 1992 edn., section 14.

[114] See for example, the 1994 Derivatives Supervision Bill presented to US House of Representatives on 26th January 1994; as reproduced in '*The Law on Financial Derivatives*', Alastair Hudson (Sweet & Maxwell, 1996), 318-331.

[115] Absent any remedy identified as a proprietary remedy above.

The courts' failure to enforce the credit enhancement and risk allocation provisions of the contracts and standard form agreements between the commercial parties to the swaps contracts, produces inequitable results between those parties, circumscribes the efficacy of English law in the context of financial agreements, and introduces further risk to financial markets by rendering otiose the terms of those standard form agreements.

The use of standard market contracts, particularly in the area of financial derivatives, sought to remove uncertainty and to control systemic risk by standardising the terms of over-the-counter agreements. Among these terms are provisions for the termination of contracts in a manner which reduces systemic risk while also reducing the immediate financial pressure on the parties to a contract on the happening of a termination event. The English courts have chosen to consider these contracts to be unenforceable. As a result, the markets' attempts to introduce effective, consensual, ad hoc regulation of the derivatives markets have been rendered ineffective.

What is not supportable is the dismay in the commercial community outside the UK which relies on English law. Lord Woolf referred to the need for a 'modern test' in financial transactions based on foreseeability of loss.[116] As Lord Browne-Wilkinson found in *Target Holdings*[117] there is a need to break from the application of traditional rules to commercial situations and consider the commercial context for equity. Lord Nicholls has accepted the need to recognise inappropriate risk-taking by a fiduciary as a ground for a claim in equity.[118] In the context of financial contracts, equity must accept the need to account for risk and suitability of product. As a corollary to this, it must enforce the common intention of the parties as to the termination of financial contracts.

The *Islington* litigation has generated enormous concern among commercial people. At one level that concern is simply grounded in the fact that the banks did not get what they wanted. On another level the concern is based on a concern that the technical rules surrounding compound interest precluded the parties from terminating their transaction on payment of the amounts which commercial people would have expected to have become due. There are larger concerns as to the efficacy of standard market agreements, totally ignored by the English courts in the swaps cases, which were framed by market users as an ad hoc regulation of systemic risk in the derivatives market. This failure to apply the terms of those contracts raises problems generally of the way in which proprietary rights could be asserted in financial contracts in future in a way which guards against the failure of the contract itself, and also of the ability of globalised marketplaces to rely on English law to assist them in standardising risk by means of documentation and thus controlling it.

There are a number of questions for the legal technician arising from that same litigation. First is the conflict between equity and restitution. Restitution is championed by a group of academics, operating from Oxford for the most part, who

[116] *Islington* [1996] A.C. 669, [1996] 2 All E.R. 961, 1016; citing, with approval, Dr F.A. Mann 'On Interest, Compound Interest and Damages' (1985) 101 LQR 30.
[117] [1996] 1 AC 421.
[118] *Royal Brunei Airlines v. Tan* [1995] 2 A.C. 378.

see it as a means of balancing out the laws of obligations and wrongs with a third code that prevents cases of injustice slipping between the cracks in the common law and statute. The equity lawyers see that as their preserve. As such, Lord Browne-Wilkinson went to great lengths in *Islington* to dismiss the applicability or utility of Birks' model of the resulting trust motivated by restitution and to set out the fundamental principles of the law of trusts which were to deal with the issue instead.

The scope of the argument in the House of Lords was between the generations of restitution lawyers (typified by Lord Goff), the traditional trusts lawyers (the majority in the House of Lords in *Islington*) and the realpolitik commercial lawyers (typified by Lord Woolf). Within these ranks are the new restitution lawyers such as Birks who are motivated by more technically-focused analyses of property rules and unjust enrichment than Lord Goff's desire to achieve 'justice' through an award of compound interest. Similarly, Lord Browne-Wilkinson is identified as a 'traditional' trusts lawyer in this work despite countenancing a need for equity to develop in commercial situations and move away rules which were originally founded to deal with family trust situations. Similarly, Prof. Hayton has argued for the introduction of a form of constructive trust which gives the judges greater freedom to frame appropriate remedies for the facts in front of them. This [work] has drawn on the work of Prof. Hayton to frame a form of common intention constructive trust which would be suitable for equity to examine financial and commercial transactions.

Second, among the interesting features of *Islington* is the role of risk in commercial equity. While the courts in the swaps cases were quick to dismiss any argument based on risk allocation (despite the terms of the contracts effected between the parties), there are a number of recent cases dealing with equitable institutions and remedies which have concentrated as risk as a lithmus test for the availability of the equitable response sought. For example, the test for dishonest assistance expressly incorporates reckless risk-taking as being among its definition of 'dishonest'. Similarly, the allocation of risks in current portfolio theory has played a part in understanding the duties of trustees in respect of the investment of trust funds. The question is then the role of risk in deciding the allocation of proprietary and personal rights in equity and restitution. There may be situations in which the parties have sought to allocate risks and thereby rights in specific property or to amounts of money. In such cases, the allocation should be protected as manifesting the common intention of the parties. Alternatively, there may be situations where a party is forced to take a risk which it did not intend to take. In such circumstances, the forced taking of the risk ought to be remedied by a proprietary remedy which would place the wronged party in the position it would have occupied but for that risk.[119]

Third, the concept of money itself continues to be difficult in English law. Apart from the difficulty of seeing money as a physical chattel in all cases, there is a problem with understanding the intangible nature of the property with which financial institutions are concerned. In contracting a financial derivative, obligations are made and undertaken to transfer amounts of value between electronic accounts. Therefore, there is a need for English law to understand the nature of that value in property law terms. As discussed in *The Concept of Money* there are difficult jurisprudential questions of

[119] The other party would simply need to re-price the transaction to absorb its own potential liability.

the precise nature of the property envisaged by English law when granting rights in rem.

It is contended that contracts surrounding money held in electronic bank accounts ought to consider property rights in terms of rights between individuals rather than as full rights *in rem*. The money in the electronic bank accounts is 'virtual money'. That is, there is no money which has ever been deposited as notes and coins in a bank which is equal to the amounts involved in those transactions. Rather the counterparties are trading value held in bank accounts. That value is created in the form of debts with the institution holding the account or loans which constitute permissions to pledge virtual money up to a certain amount. It is difficult to see how there could ever be a right in rem in respect of something which has never existed. There has never been 'a thing' which could be the object of that right. Rather there is only ever an obligation to pay or receive amounts of value by reference to a further chose in action - the bank account. While such choses in action are themselves considered to be money, they are not chattels in the manner which Lord Browne-Wilkinson considers them. Rather, they are intangibles, promises to pay. They are 'virtual' money contracted in the virtual reality of the financial markets.

Therefore, in deciding whether or not a proprietary remedy is appropriate, what is at stake is the size of the return which is to be awarded in respect of value of that nature and that size. As considered by Lords Goff and Woolf, the justice of the situation was that compound interest ought to be paid even though a proprietary remedy was expressly disavowed by their lordships. That is the error, it is submitted, of the two partially dissenting speeches in *Islington*. An award of compound interest in a situation where value calculated in a particular currency is paid and owed, would be an award based on continued ownership of that value throughout the life of the transaction. On the facts in *Islington* that value had been transferred outright to the authority. Therefore, when Lords Goff and Woolf refused a proprietary award but yet contend that compound interest ought to be paid, they were granting a proprietary remedy in fact. The logical leap in their reasoning was not accounting for the nature of the property. The property was value held in an electronic bank account - an obligation to pay money. This fits more closely with Hohfeld's analysis of property rules as being obligations between persons rather than being 'rights in a thing'.

Fourth, following on from the discussion of the nature of 'money', is the problem of reserving proprietary rights over such property or ensuring some means of credit support. This cuts to the heart of the use that commercial markets make of English property law. Failure to support the common intentions of commercial people to rights in property, or awards tantamount to such rights, weaken the confidence of all users in that code. On the agreements before the courts in the swaps cases there must be some doubt as to the efficacy of the proprietary claims made by the banks. The BBAIRS agreement and the ISDA agreement simply did not protect the participants in the manner they would have wanted. However, that does not staisfy a need for the courts to examine the extent of those shortcomings and to give some clue as to the future. It is contended that the suitability approach, specifically through the use of common intention constructive trusts and the doctrine of undue influence, ought to be able to regulate the availability of proprietary rights and security for commercial transactions.

Fifth, the approach of equity to commercial cases in decisions involving and contemporaneous to the swaps cases demonstrates a significant undercurrent of change in the form of its principles. The test for a constructive and resulting trust in *Islington*, the test for dishonesty in *Tan* and the drift of common intention constructive trusts cases like *Lloyds Bank v. Rosset* in the speech of Lord Bridge, have seen a solidifying of the techniques of equity into hard and fast rules. While common law appears to loosening itself in the torts discussed above, equity is moving in the opposite direction. As such it is proposed that the suitability approach outlined above constitutes a part of this reformulation of equity in response to changing subject matter.

Sixth, the question remains: what is a swap? This [work] has sought to explain in a little more detail than the swaps cases did the breadth of the derivatives firmament and also to consider the different impacts of the various possible analyses of similar transactions. The core of this analysis is based on swaps pricing models and credit risk models, both of which are central to the formation of a derivative. Rather than viewing a swap as a transaction which is always the same as the one before and the one after, it is important to construe financial derivatives in the same way that other commercial and shipping contracts are typically construed in detail. To achieve this construction it is important to look at the commercial purpose of the transaction. That commercial purpose (be it hedging, speculation or otherwise) will indicate the appropriate analysis of the transaction. Consequently, the appropriate equitable or restitutionary response will emerge.

While this thesis has argued for a different approach from the courts to complex financial and commercial transactions, it has not sought to protect those markets mindlessly or even to argue that the swaps cases were wrongly decided on their facts given the shortcomings of the standard market contracts used at the time. The broader understanding which informs this [work] is that the world is becoming a more complex place in which it is less possible for the courts to rely on the breadth of arcane equitable principles such as 'he who comes to equity must come with clean hands' in situations where commercial people are creating contracts born out of complex mathematical understandings of the world. For the autopoietic theorists this is a situation in which different social systems have failed to meet and communicate - that they have 'irritated' one another. The legal system has not been [120]able to translate the operations of the global financial system in a way that enables one to understand the complexities of the other. The result is a continuation of the doctrinal conflicts within the English legal system and a problem for the financial world to ensure that their transactions are properly secured.

For the sociologists like Giddens globalisation is something broader than the operation of financial markets across geographic boundaries.[121] Globalisation refers to a systematic change in social relations. While it incorporates the growth of international and supra-national control of government, administration, regulation and economics, it also refers to a centralisation of governmental power away from local authorities while at the same time requiring the individual to make more decisions which would

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121 *Beyond Left and Right*, Giddens (Polity Press, 1994).

otherwise have been made for them. At one level, this arises from the deconstruction of economies built around heavy industry together with the broadening of economic opportunity. The range of options produced creates problems for the individual in a way which a lack of choice never did.[122]

The financial derivatives market is an illustration both of the growth of international possibilities for action with a greater range of choices for actors. The ability to speculate through derivatives without needing to enter into a market physically is one manifestation of this globalisation, as is the ability to restructure contractual loan obligations through interest rate swaps. The techniques, in the best postmodern tradition, are both simple and very complex. The swaps cases have shown English law to be caught between very simple, intuitive ideas and subject matter too complex to analyse closely. The role of restitution and of equity is to address itself to that form of social realignment: to provide justice in a more difficult and more complicated world than the one which produced them originally.

[122] *Modernity and Self-Identity*, Giddens (Polity Press, 1991).