"Understanding the Irritation between Restitution and the Law of Finance"

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This essay is an early version of what became a chapter in *Lessons from the Swaps Cases,* ed. Birks (t.b.p. Oxford University Press, 1999).

The purpose of this essay is to analyse the subject matter of the local authority swaps cases from the point of view of a lawyer specialising in interest rate swaps and in financial transactions more broadly.[1] There are as many lessons to be learnt by the banking lawyers as by the restitution lawyers - perhaps even more so.

In the wake of the local authority swaps cases, the question remains: what is a swap?[2] There remain a number of issues surrounding the nature of the reciprocal obligations created under a swap contract. Theorists of autopoiesis talk of there being systemic "irritation" when two systems such as law and global financial markets come into conflict in such a way that their respective vocabularies and practices cannot inter-act. That inability to communicate the concerns of one into the decisions of another is the root of the swaps cases. In relation to financial transactions, equity needs to adopt a different approach as to the nature of an equitable remedy between commercial parties acting at arm's length.

The core concerns

This essay highlights three key issues arising from the *Islington*, and related, litigation. First, that the courts failed to take into account the nature of interest rate swaps and their necessary allocation of risks between counterparties. Second, the problems created for the law of restitution by English law's conception of money as tangible property rather than as intangible choses in action held in electronic accounts. Third, the problem of taking security in financial transactions as a result of the decision of the House of Lords (and by using standard market contracts as currently constituted).

The underlying theme of the essay is the conflict between the attitudes of traditional trusts lawyers and the proponents of the emerging principle of restitution of unjust enrichment. The essay sets out new models for problems of equitable proprietary claims, and claims aimed at the reversal of unjust enrichment founded on suitability, based on existing caselaw. It will also seek to employ other techniques (such as

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[1] For a fuller account of the nature of financial derivatives, see Hudson, *The Law on Financial Derivatives* (2nd edn., London, Sweet & Maxwell, 1998), Part I.

[2] The author has spent some considerable time on this issue in *The Law on Financial Derivatives* (2nd edn., London, Sweet & Maxwell, 1998), 34-75; and *Swaps, Restitution and Trusts* (London, Sweet & Maxwell, 1999), 19-64. It is submitted that, in any event, the sketchy description provided by Lord Woolf in *Hazell* in the Court of Appeal does not address half of the questions.

common intention constructive trusts, the doctrine of severance and the doctrine of undue influence) and suggest, heretically, that they have a role to play in the context of equitable solutions to commercial disputes.

A brief map of the swaps cases

There are many cases at issue when we talk of the "local authority swaps cases". This essay provides a necessarily brief analysis and focuses in the main on *Westdeutsche Landesbank v. Islington L.B.C.* ("*Islington*"),[3] which is the most important development (or retrenchment) in the law of trusts for a generation.[4] The most recent development (at the time of writing) was the House of Lords' decision in *Kleinwort Benson v. Lincoln City Council* ("*Lincoln*")[5] to abolish the rule against actions for restitution founded on mistake of law. This decision is considered below, in part through its impact on the Court of Appeal's decision in *Guinness Mahon v. Kensington & Chelsea R.L.B.C.* [6] as to the distinction between part-performed and completed transactions at the time of the decision in *Hazell.*

There are a number of other decisions advancing separate fronts in the growing law relating to derivatives products. The source of all the trouble was the difficult decision in *Hazell v. Hammersmith & Fulham* ('*Hazell*')[7] which revolved around an esoteric reading of the Local Government Act 1972 which had long been taken to grant capacity to local authorities to enter into interest rate swaps transactions. Much of that decision revolved around an underlying conviction that there is something necessarily suspicious about derivatives.[8] This conviction was perpetuated by Hobhouse J. in the contracts for differences case *Morgan Grenfell v. Welwyn Hatfield DC and others*[9] ('*Welwyn*') under which it was held that interest rate swaps were only preserved from being classified as gaming contracts by the saving provisions of the Financial Services Act 1986. There remains at large the issue as to whether or not derivatives products which hedge against market movements are in fact insurance contracts within the Insurance Companies Act 1986.[10]

In relation to the issues concerning restitution of money paid, there were joined appeals at first instance in *Islington* in which Westdeutsche Landesbank Girozentrale proceeded against the London Borough of Islington ('*Islington*')[11] and Kleinwort Benson proceeding against Sandwell Borough Council ('*Sandwell*').[12] 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

[3] [1996] AC 669.
[4] This discussion is advanced in greater detail in Hudson, *Swaps, Restitution and Trusts* (London, Sweet & Maxwell, 1998), especially 198-229.
[5] [1998] 4 All ER 513.
[6] [1998] 2 All ER 272.
[7] [1991] 1 All ER 545, HL.
[8] See in particular Lord Templeman at [1991] 1 All ER 545, 549.
[9] [1995] 1 All ER 1, Hobhouse J..
[10] See Hudson, *The Law on Financial Derivatives* (2nd edn., London, Sweet & Maxwell, 1998), 150.
[11] [1994] 4 All ER 890, Hobhouse J., CA; [1996] AC 669, HL.
[12] [1994] 4 All ER 890, Hobhouse J.. The *Sandwell* action did not proceed beyond first instance.

('*Birmingham*')[13] and against South Tyneside Metropolitan Borough Council ('*South Tyneside*')[14].

The nature of global markets whose existence is predicated on the need to manage, and the possibilities to exploit, financial risk raise a range of conflict of laws issues. Some of these were considered in *Kleinwort Benson v. Glasgow C.C.*[15] Other decisions have confined themselves to the nature of the documentation between parties to interest rate swaps,[16] the liability for sellers of complex derivatives products,[17] and the nature of derivatives as contracts for differences in themselves.[18]

The potential lessons from the swaps cases demonstrate something about the nature of financial markets, their frequent carelessness in respect of the detail of legal risk, and the very broad range of issues which their innovative energies will tend to generate. The lessons for the banking lawyer are both technical and ideological - demonstrating a need for better management of substantive law as a risk. The aims of this essay are, however, far more focused than that. Analysis will be limited to the core concerns outlined above with reference to the application of principles of equity in commercial contexts.

On the nature of commercial equity

The core problem for equity in the swaps cases is that the traditional rules relating to the availability of proprietary remedies sit uneasily in the commercial context. Principles created with family trusts in mind, do not respond well to the requirements and challenges of commercial contracts. Complex subject matter from the world of global finance has intruded on an ideologically fundamental debate about the nature of claims for recovery of property or value. The dangers of this mismatch were recognised by Lord Browne-Wilkinson in *Target Holdings*[19]:-

> 'In the modern world the trust has become a valuable device in commercial and financial dealings. The fundamental principles of equity apply as much to such trusts as they do to the traditional trusts in relation to which those principles were originally formulated. But in my judgement it is important, if

[13] *Kleinwort Benson* v. *Birmingham City Council* [1996] 4 All ER 733, CA, on appeal from Gatehouse J., (unreported).
[14] *Kleinwort Benson* v. *South Tyneside M.B.C.* [1994] 4 All ER 972, Hobhouse J..
[15] [1997] 4 All ER 641.
[16] *Nuora Safim SpA v. Sakura Bank Ltd* [1998] CLC 306, as to the standard form of default provisions in the International Swaps and Derivatives Association ("ISDA") Multicurrency Master Agreement used by the interest rate swap market. See also *Bank of Scotland v Dunedin Property Investment Co Ltd* [1997] CLC 918.
[17] *Bankers Trust International PLC v. PT Dharmala Sakti Sejahtera*, *ibid*; and US litigation such as *Gibson Greetings v. Bankers Trust Co* Civil Action No. C-1-94-620 (S.D. Ohio, filed September 12, 1994), *Proctor and Gamble v. Bankers Trust Co.* Civil Action No. C-1-94-735 (S.D. Ohio, filed February 6, 1995); Craig and Hume, "Customers: recent litigation between derivatives dealers and their customers …", (1995) *Columbia Law Review* 167; H. Scott, "Liability of Derivatives Dealers", F. Oditah ed. (Oxford, Clarendon Press, 1996), 271; and H. Picarda, "Interest Rate Swap Agreements in the Courts" [1996] BJIBFL 170.
[18] *Morgan Stanley UK Group v. Puglisi Cosentino* [1998] CLC 481.
[19] [1996] 1 AC 421; [1995] 3 All ER 785, 795..

> the trust is not to be rendered commercially useless, to distinguish between the basic principles of trust law and those specialist rules developed in relation to traditional trusts which are applicable only to such trusts and the rationale of which has no application to trusts of quite a different kind.'

In line with this acceptance of the need for equity to become relevant to commercial situations, it is contended that there is a need to develop specialist rules for new contexts, rather than to attempt to make new wine and old skins work together. It is somewhat ironic that it was Lord Browne-Wilkinson who sounded the call for equity to adopt a new approach in the commercial context, before then delivering the leading speech in *Islington* in which the existing rules of equity were consolidated rather than new principles being created.[20]

There is a challenge for existing legal structures to consider the manner in which they interact with commercial transactions. From the earliest cases, the role of equity has been seen to be 'to correct men's consciences for frauds, breach of trust, wrongs and oppressions.'[21] It has therefore been concerned to mitigate the technical rigour of the common law with a moral code enforceable by the courts. The problem facing equity is that it developed as a moral code responding to a cultural understanding of property rights in the 17th century which does not correlate exactly with the common contractual intentions of the parties to complex financial transactions at the end of the 20th century. The novel uses of equitable concepts in this essay seek to demonstrate some possibilities for the progress of equity, or a principle of unjust enrichment, to meet those requirements.

One development in the principles of equity has been the increased rigidity of the tests which the courts are applying, particularly in commercial contexts. This tendency has been particularly discernible in the speeches of Lord Browne-Wilkinson in *Islington*, *Tinsley v. Milligan*[22] and *Target Holdings*,[23] the decision of the Privy Council in *Re Goldcorp*[24] and in the speech of Lord Nicholls in *Royal Brunei Airlines v. Tan*.[25] In each of these cases there is a two-fold development: the solidifying of the appropriate test, and a restatement of the principles on which equity operates. Not only have the tests changed the law but they have moved it towards a greater level of certainty which typifies common law, rather than equitable principles.

Within the terms of the substantive tests that are being applied, however, there remains a broad brush approach to judicial control. While there is an intention to set out clear tests, the manner in which those tests are being applied goes beyond a simple application of those rules. One good example of this development appears in the decision of the Privy Council in *Royal Brunei Airlines v. Tan*.[26] The principle of

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[20] Albeit controversially in terms of the nature of "common intention resulting trusts", and other peculiarities.
[21] *Earl of Oxford's Case* (1615) 1 Ch Rep 1 at 7; 21 ER 485 at 486.
[22] [1994] 1 AC 340.
[23] *Target Holdings v. Redferns* [1996] 1 AC 421, [1995] 3 WLR 352, [1995] 3 All ER 785.
[24] [1995] 1 AC 74.
[25] *Royal Brunei Airlines v. Tan* [1995] 2 AC 378.
[26] [1995] 2 AC 378.

dishonesty in *Tan* is broadened far beyond any of the more usual tests of whether or not a person is 'dishonest' *stricto sensu*.

Classifying claims

In English law there are distinctions to be made between types of claims and remedies which are available in the financial derivatives context for some misfeasance by the seller of a product.[27] Those claims are analysed here as falling into three categories: claims arising out of contract, trust or estoppel (consent), claims arising out of tort and equitable wrongs (wrongs), and claims arising on the basis of some the unjust enrichment of the defendant or from some unconscionable act by one or other of the parties (unjust enrichment).[28]

The 'consent' category includes issues which have arisen from the contractual or pre-contractual agreement of the parties. Typically such claims will arise out of the law of contract. Claims based on this category tend to revolve around factual issues as to agreement and remedies based on common law, such as damages for breach of contract, or in equity such as specific performance, injunctions, equitable accounting or compensation. For the most part, claims based on 'consent' will tend to settle in the marketplace, unless one of the parties has become insolvent.

The claims based on 'wrongs' will generally revolve around a claim which, in the context of derivatives, is based on the suitability not only of the product sold for the client and for the purpose, but also the suitability of the method by which it was sold and structured. Generally it could be anticipated that a claim in suitability would be brought by a non-financial institution seeking a remedy from a bank which wrongly sold it a particular derivative product. The wrong complained of might fall into one of a number of factual categories:-[29]

(1) that the seller made a misrepresentation or misstatement as to the intrinsic nature and structure of the derivative;
(2) that the seller ought to have given fuller advice as to the effect and risk-profile of the derivative;
(3) that the derivative itself was unsuitable for the purpose for which it was sold and acquired;
(4) that the derivative itself was simply unsuitable for that buyer in all the circumstances; or
(5) that some mistake was made in the course of selling, describing, analysing, pricing, constructing or implementing the derivative which caused the derivative to be unsuitable.

[27] See perhaps R. Cranston, "Banks, Liability and Risk", in *Banks, Liability and Risk*, Cranston ed. (London, Lloyds of London Press, 1995), 1-14.
[28] See perhaps Birks, 'Trusts Raised to Reverse Unjust Enrichment: The *Westdeutsche* Case' [1996] RLR 3, 26.
[29] On the breadth of these claims see the decision of Mance J. in *Bankers Trust International PLC v. PT Dharmala Sakti Sejahtera* [1996] CLC 518.

Evidently a number of well understood claims in the law of tort emerge from this list: misrepresentation, negligent misstatement, negligence, or potentially fraud. Similarly some other claims may emerge on these facts which are not necessarily based on tort: mispredictions, breach of fiduciary duty, or failure to comply with regulatory standards as to client business rules. The category of mistake for which relief is given, whether or fact or law, is wider in the law of unjust enrichment than in contract.[30]

The claim in unjust enrichment would be a claim mounted on any one or more of the following factual bases[31]:-

(1) to recover specific property lost as a result of the supply of some unsuitable financial derivative product;
(2) to acquire specific property in satisfaction of a claim concerning other specific property lost as a result of some supply of an unsuitable financial derivative product;
(3) to order payment of money in compensation for some loss suffered as a result of some unsuitable financial derivative product[32]; or
(4) to impose financial or fiduciary responsibility on the defendant in respect of some loss suffered as a result of some unsuitable financial derivative product.

There is some potential overlap between the factual basis of some of the claims in wrongs and these claims in unjust enrichment. The basket category 'unjust enrichment' itself would appear to classify as exclusively restitutionary those remedies and claims which are properly equitable[33] - particularly in the light of the attitude of the majority of the House of Lords in *Islington*.[34] The claim to recover specific property relies on there being some proprietary right to trace or claim against that property. To a restitution lawyer this claim achieves restitution of that property;[35] to the trusts lawyer it is the assertion of a common law or equitable tracing claim against that property.[36]

In attempting to reach a catch-all standard for claims in relation to complex financial transactions, a test of "suitability" would be the most apposite. In this context "suitability" is meant both in terms of suitability of the product for the purpose and

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[30] Now *Lincoln* op cit.; *Restitution: Mistakes of Law and Ultra Vires Public Authority Receipts and Payments* (1994), Law Comm. No. 227; J. Beatson [1995] RLR 280; G. Virgo, "Striking the Balance in the Law of Restitution" [1995] LMCLQ 362; *Air Canada v. British Columbia* (1989) 59 DLR (4th) 161; *David Securities Pty Ltd v. Commonwealth Bank of Australia* (1992) 175 CLR 353; .

[31] Although the third and fourth categories might more commonly be categorised as relating to common law or equitable wrongs.

[32] The point made in Hudson, *Swaps, Restitution and Trusts* (London, Sweet & Maxwell, 1999), 199-249 being that unsuitable selling practice ought properly to be considered as a form of unjust enrichment on the part of a seller of a financial product where that seller is exploiting a disparity in expertise or information.

[33] Although there are equitable remedies such as the compensation in *Target Holdings v Redferns* might not fall to be categorised as truly restitutionary.

[34] [1996] AC 669.

[35] See L. Smith, *Law of Tracing* (Oxford, 1997), 1 *et seq.*; P. Birks, *Introduction to the Law of Restitution* (Oxford, 1989), 358 *et seq*..

[36] *Westdeutsche Landesbank Girozentrale v. Islington LBC* [1996] AC 669; *FC Jones & Sons v. Jones* [1996] 3 WLR 703.

suitability of method of sale. Thus the former would seem to involve cases of fraud, dishonest assistance and negligence, whereas the latter may raise issues of undue influence. Suitability is described by some of the commentators as an 'emerging standard'[37] derived from US financial regulation and as emerging from UK financial regulation.[38] For example the Bank of England Code of Conduct[39] and the SIB's conduct of business rules[40] deal with derivative transactions under which private customers have a contingent liability to make payments at some time in the future, have come to be adopted by banking lawyers[41] and the courts[42] as a foundation for the development of common law standards in relation to wrongs and claims based on unjust enrichment.

The policy aim of the regulatory principles is to protect customer rights by ensuring the suitability of seller's product recommendations and discretionary transactions. The regulation of such agreements requires that there is no restriction on the part of the advisor to restrict its liability in respect of its obligations to advise without negligence and with due skill, care and diligence. With reference to complex financial products, which may involve derivatives, the advisor is required to ensure that the investment is suitable for that particular customer. It is suggested that these approaches are the more apposite principles for equity acting in commercial contexts.

Developing the role of constructive trust

In *Islington*, Lord Browne-Wilkinson rejected the possibility of imposing a constructive trust on the payment for the benefit of the payor. The rationale for this approach was 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 legal status of the contract until it was declared to be ultra vires by the courts in *Hazell*. However, at that point another factor ought to have impacted 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 should be sufficient to cause the authority to be bound by those terms of the swap contract on the basis that both parties had entered into the transaction in good faith, at arm's length and in pursuit of a common intention. 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

[37] Cranston, *Principles of Banking Law* (Oxford, 1997), 212.
[38] See W. Blair, *Financial Services: The New Core Rules* (Blackstone, 1991), 94.
[39] See Mance J. in *Bankers Trust International PLC v. PT Dharmala Sakti Sejahtera* [1996] CLC 518 on the role of this code in informing principles of common law in this area.
[40] SIB Rules, Ch III, Pt. 2.
[41] Hudson, *The Law on Financial Derivatives* (2nd edn., London, Sweet & Maxwell, 1998), 168-203.
[42] See for example Mance J. in *Bankers Trust International PLC v. PT Dharmala Sakti Sejahtera* [1996] CLC 518.

market standard contracts for over-the-counter derivatives is that they do not cater sufficiently for retention of title in property.[43]

A new role for common intention constructive trusts?

In considering commercial situations, the relevant rules of equity should be directed at one objective: to enforce prudential risk management provisions of the agreement arrived at consensually and mutually by the parties, except where that would be contrary to some mandatory principle of equity[44] or contrary to public policy.

In the context of a commercial agreement it is clear that there must be common intention. In a perfect world, a contract would evidence the entirety of the intentions of the parties in relation to their respective obligations, credit support issues and rights in any property transferred between them. Where there is no such agreement as to any of these questions, there could be no constructive trust based on a common intention unless that could be implied from their mutual conduct, which will require one party to act to their detriment. Where there is an express agreement between the parties as to the legal and equitable interest in property, that contract will be decisive as to matters of title. The problem is where the contract is explicit as to title in property and so forth, the contract may itself be unenforceable through illegality or incapacity.

The common intention constructive trust, as applied in the case of trusts of homes, does not require that there have been anything amounting to a binding contract to be imposed on the parties.[45] In part this is because ordinary people unversed in the niceties of the law relating to real property are not expected to have observed the formalities for creating contracts in respect of land.[46] However, where parties have agreed upon detailed contracts, based on a standard market form, and it is only the technicality of the *ultra vires* rule which has led to performance of their contract being unenforceable either at law or equity, collateral issues of credit support and proprietary rights in property ought to be governed in equity in accordance with their common intention.

It is submitted that the contracting parties can have no objection to being bound by the terms of their agreement. In situations where the formation of the agreement is said to be founded on some unjust factor (such as misrepresentation or undue influence) there would be no valid common intention to form an agreement such that the constructive trust could not be enforced. Alternatively, it cannot be said that there is any hardship to creditors of one of the contracting parties. In the event that the party is insolvent,

[43] 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, in the wake of the local authority swaps cases.
[44] Such as the principle against undue influence or against common law being used as an engine of fraud: *Barclays Bank v O'Brien* [1993] 3 WLR 786.
[45] As is clear from *Gissing v. Gissing* [1971] AC 886, *Lloyds Bank v. Rosset* [1991] AC 107, and so forth.
[46] For example, the requirement under s.2 of the Law of Property (Miscellaneous Provisions) Act 1989 that contracts in relation to land must be in writing.

the creditors could be said to receive a windfall[47] in the event that the contract is found to be unenforceable and the assets otherwise bound up in that contract are released. Otherwise, the unsecured creditors are merely prevented from proving in the liquidation against property which has been hypothecated to the derivatives contract under terms which have been held to be void. In neither case can the creditor be said to be meritorious to the extent contended for by the House of Lords.

Indeed, the House of Lords in *Islington* were unanimous in their desire to protect ordinary creditors of an insolvent party in a bankruptcy. However, it is contended that there is no reason to protect ordinary creditors beyond ensuring that one category of unsecured creditors does not gain an unjustified advantage[48] over the other unsecured creditors. There is no reason why ordinary creditors should obtain preference over parties who have sought to protect themselves by retaining some proprietary interest under a contract which has subsequently been held to be void. The predeliction for the protection of those who have not acquired proprietary protection for themselves simply fails to recognise that it is the market economy which is at fault in creating inequalities of bargaining power such that some parties acquire secured rights while others do not.[49] The weakness of the *Islington* decision in this respect is that it precludes the contracting parties from seeking to allocate responsibility and proprietary rights. The strength of the model based on the common intention constructive trust is that it observes the freedom of the parties to contract and thus restricts the scope for systemic risk as set out above.

The criticism of the common intention constructive trust has been based primarily on its reliance on an implied agreement where no such agreement has never existed. However, the English concepts of equity have great use for legal fictions of this sort. For example, the mutual conduct common intention constructive trust[50] is simply self-contradictory. Where there is no express agreement of any kind between the parties, the court has given itself the power to assume from the behaviour of the parties that they would have reached a particular agreement had they been appraised of the legal context. Therefore, they are treated as having created an agreement where there was none. That is a legal fiction. There are other complaints which are specific to the context of the family home and purchase trusts: for example the necessity that there have been some direct contribution to the mortgage repayments or purchase price[51] rather than any more general contribution to familial expenses.[52] Those issues need not detain us here, not being relevant to the commercial context.

The more important point is the potential utility of the notion that a common agreement may grant an equity in itself. Unlike the family homes cases, in the context of commercial contracts there *is* an agreement between the parties which is acted upon

[47] That is, by the addition of more assets to the insolvent estate in which title would otherwise have been allocated by contract.
[48] Beyond what is preserved by statute.
[49] The writer has argued elsewhere that it is the role of government to intervene in situations where it is considered that such inequalities of bargaining power are insupportable: see *The Law on Financial Derivatives* (2nd edn., Sweet & Maxwell, 1998).
[50] As upheld in *Lloyds Bank v. Rosset* [1990] 1 All ER 1111.
[51] *Lloyds Bank v. Rosset , op cit.* at 1119, *per* Lord Bridge.
[52] *Burns v. Burns* [1984] Ch 317.

by the parties when they make payments or enter into hedging transactions to their detriment.[53] 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.

Part-performed and fully-performed contracts

Birks has advanced the contention that there ought to be a difference in the forms of restitution available between part-performed and fully-performed contracts.[54] This point was considered by Hobhouse J. in *Sandwell*[55] and in *Guinness Mahon & Co Ltd v. Kensington and Chelsea Royal London Borough Council*.[56] The question was whether there ought to be a different analysis of the availability of restitution in relation to interest rate swaps, which continue typically for a number of years, which have been part-performed and those interest rate swaps which have expired due to full performance. Hobhouse J. chose to make no distinction between such open and closed swaps without detailed explanation.

The matter received closer attention in *Guinness Mahon* where the local authority sought to argue that, because the swap was a closed swap (that is, a swap under which all payments had been completed), it ought not to be required to make restitution to the bank. The authority's arguments were twofold: first, that there was no failure of consideration because both parties paid and received what they had bargained for; and, second, that the interest rate swap agreement ought to be subjected to the doctrine of apportionment of consideration (or severance) with the result that the transaction should be treated as having expired.

The first argument on behalf of the authority was disposed of by Morritt LJ on the basis that it would be absurd to permit a distinction in the availability of restitution on the basis of whether or not the swap was open or closed. Morritt LJ held[57] that the underlying purpose for the Court of Appeal's decision was a general policy of supporting the doctrine of *ultra vires* on the basis that it existed to protect the public. The second argument on behalf of the authority was rejected on the basis that to have precluded restitution in favour of the bank because the swap was closed would be to give effect to the transaction by covert means once the overt means of enforcement had been precluded by the judgement in *Hazell*: effecting the transaction 'by the back

[53] On the latter point see, however, *Kleinwort Benson v. Birmingham City Council* [1996] 4 All ER 733, CA.
[54] "No Consideration: Restitution after Void Contracts" (1993) 23 UWALR 195.
[55] [1994] 4 All ER 890.
[56] [1998] 2 All ER 272.
[57] [1998] 2 All ER 272, 284.

door'. The underlying thrust of the judgement was summarised by Morritt LJ as follows:-[58]

> "(1) A contract which is ultra vires one of the parties to it is and always has been devoid of any legal contractual effect.
> (2) Payments made in purported performance thereof are necessarily made for a consideration which has totally failed and are therefore recoverable as money had and received."

This analysis raises the question whether or not severance of the contract should be possible, as considered immediately below. This was a point not raised in argument before the Court of Appeal. Morrit LJ held that there was never any valid interest rate swap with the effect that the there could be no contractual terms which could have been effected. As a result, none of the payments made between the authority and the bank were enforceable in contract.

The authority failed to resist the bank's claim for restitution of the net balance of money paid under the interest rate swap payment on the basis of complete performance of the agreement. This point was considered in *Lincoln*. In the opinion of Lord Goff, considering Birks' argument in some detail, that to permit a difference between closed and open transactions would enable the parties to elude the mandatory nature of the *ultra vires* rule. This argument is considered below.

Severance

In respect of the void swaps contracts, it is suggested that even in the case of contracts which are found to be void *ab initio* with reference to their core commercial purpose, it is open to the court to seek to apply the risk management provisions of those agreements even though the remainder of the contract fails. The proposed approach is based on the application of the doctrine of severance. In short, the application of this doctrine would permit the reduction of systemic risk in commercial contracts by giving effect to those prudent elements of contractual agreements[59] which do not offend against public policy.

The classic statement of the doctrine of severance is that: 'where you cannot sever the illegal from the legal part of a covenant, the contract is altogether void; but, where you can sever those parts, whether the illegality can be created by statute or by common law, you may reject the bad part and retain the good.'[60] In *Spector v. Ageda,*[61] Megarry J. 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*

[58] [1998] 2 All ER 272, 284.
[59] Whether negotiated on a bespoke basis or founded on standard market contracts.
[60] *Pickering v. Ilfracombe Railway* (1868) LR 3 CP 235, 250; *Payne v, Brecon Corporation* (1858) 3 H. & N 572; *Royal Exchange Assurance Corporation v. Siforsakrings Aktiebolaget Vega* [1901] 2 KB 567, 573; *Chitty on Contracts,* 27th edn. (London, Sweet & Maxwell, 1994), para. 16-165.
[61] [1973] Ch 30.

Petroleum v. Harper's Garage (Stourport) Ltd[62] 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.

It is not an immutable rule at English law that a contract void *ab initio* is necessarily completely inefficacious in any event. Further to the availability of the doctrine of severance, it has been held, primarily in the context of insurance and shipping contracts, that contracts void *ab initio* can nevertheless be held to be valid to the extent of jurisdiction clauses and arbitration clauses. In *FAI General Insurance v. Ocean Marine Mutual*[63] the court found that simply because a contract for reinsurance was held to have been void *ab initio* did not necessarily preclude the efficacy of the jurisdiction clauses and arbitration clauses in that agreement.[64]

From a number of the severance cases, a general principle emerges to the effect that the parties should be held to their bargain in the absence of public policy constraints to the contrary.[65] It is suggested that this principle ought to apply to the risk management provisions of a financial derivatives contract. The risk management features of standard market financial documents introduce greater certainty by reducing to net cash amounts those sums 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 be void.[66]

The problem with the application of this principle is the fundamental assertion by the courts in the swaps cases that the *entire* contract was void *ab initio*. The courts ignored the risk allocation and security provisions contained in the master agreements.[67] It is the complete avoidance of the swaps contracts on the basis of public policy which militate most strongly against application of the credit support or termination provisions set out expressly in the standard market contracts.[68] The central question is, therefore, as to the basis for public policy in this area. From the perspective of systemic risk management in financial markets, the most appropriate policy is to respect the market practice of controlling risks through standard contracts

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[62] [1968] AC 269, 314, 321.
[63] [1998] Lloyd's Rep IR 24.
[64] *Mackender v. Feldia AG* [1967] 2 QB 590; *Woolworths Ltd v. McMillan* (Rogers J., February 29, 1988, unreported; *Harbour Assurance Co (UK) Ltd v. Kansa General International Insurance Co Ltd* [1992] 1 Lloyd's Rep 81.
[65] *Huddart Parker Ltd v. The Ship "Mill Hill"* (1950) 81 CLR 502; *Oceanic Sun Line Special Shipping Co Inc v. Fay* (1988) 165 CLR 197; *Akai PtyLtd v. Peoples Insurance Co Ltd* (1995) 8 ANZ Ins. Cas. 161; *The Eleftheria* [1970] P. 94; *The El Amria* [1981] Lloyd's Rep 521; *Citi-March Ltd v. Neptune Orient Lines Ltd* [1996] 1 WLR 1367, [1996] 2 All ER 545; *FAI v. Ocean Marine* [1998] Lloyd's Rep I.R. 24.
[66] *Gaskell v. King* (1809) 11 East 165; *Gibbons v. Harper* (1831) 2 B & Ad 734.
[67] Alternatively, the issue arises whether any credit support documentation, being collateral to the void contract, could be effective against the defaulting party. The doctrine of severance would suggest that any collateral credit support documentation could be made effective against the counterparty.
[68] *Kuenigl v. Donnersmarck* [1955] 1 QB 515; *Hyland v. Barker* [1985] ICR 861, 863.

and to recognise the impact these provisions have on lowering systemic risk in relation to financial derivatives contracts.

The doctrine of severance might also apply with reference to the distinction between executed and non-executed transactions.[69] 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 the risk allocation provisions designed to cover the risk which has materialised.[70] The House of Lords has expressed its unanimous opinion that there ought to be no difference in the principles of restitution governing these types of contract,[71] as did Hobhouse J. in *Sandwell*.[72]

Enforceability of illegal contracts

Progressing from the problems of offending policy principles in respect of closed and open swaps, it is possible for even illegal contracts to be enforced in part in equity.[73] The long-established principles of equity in this context were re-drawn by the House of Lords in the case of *Tinsley v. Milligan*.[74] Lord Browne-Wilkinson indicated that contracts are capable of being enforceable in part despite being intrinsically unlawful, in the following circumstances:-

> (1) Property in chattels and land can pass under a contract which is illegal and therefore would have been unenforceable as a contract.
> (2) A plaintiff can at law enforce property rights so acquired provided that he does not need to rely on the illegal contract for any purpose other than providing the basis of his claim to a property right.
> (3) It is irrelevant that the illegality of the underlying agreement was either pleaded or emerged in evidence: if the plaintiff has acquired legal title under the illegal contract that is enough.

His lordship found that the earlier cases also showed that the plaintiff ought to be entitled to enforce an interest under a resulting trust where she did not have to rely on her illegality to do so. It does appear that his lordship is seeking to develop a resulting trust based on "the common intention of the parties" rather than one which, *strictu sensu*, gives effect to the intention of the settlor.[75] On extending this thinking, it is not clear why the common intention of the parties evidenced by their *ultra vires* contract, cannot be effected to the extent that it is not *ultra vires*. In accordance with the

[69] *Guinness Mahon v. Kensington & Chelsea R.L.B.C.* [1998] 2 All ER 272.
[70] See, for example, ISDA Multicurreny Master Agreement 1992, at s.3.
[71] *Lincoln,* [1998] 4 All E.R. 513.
[72] *Sandwell,* [1994] 4 All E.R. 890. This point was considered in Hudson, *Swaps Restitution and Trusts*, op cit., 15.
[73] The emerging regulation of derivatives in the global context does mean that regulation, criminalisation and prohibition of are factors which emerge after market counterparties have begun to contract those derivatives products.
[74] [1993] 3 All ER 65, [1993] 3 WLR 36.
[75] See on this Chambers, *Resulting Trusts* (Oxford, 1997) generally.

doctrine of severance, as considered above, there appear to be equitable grounds for giving partial effect to contracts which are unenforceable *in toto*.

Fiduciary obligations and undue influence

The relationship of banker and client will not necessarily import a fiduciary relationship, although there are a number of situations in which a fiduciary relationship will arise: where the bank induces business by agreeing to become financial advisor,[76] where the bank advises a customer to enter into a transaction,[77] and where the advises a person to enter into a transaction which is to their financial disadvantage without ensuring that they have taken independent advice.[78] In the case of derivatives, liability potentially arises for advice given to a client with respect to selling financial derivatives.

Where the client is entirely reliant on the expertise of the advisor, there is a liability for the advisor not to exert undue influence over that client by selling them products which are to their financial detriment in situations where they have reposed trust in the advisor. The application of this principle in the recent mortgage cases has revolved around the relationship of 'special tenderness' between husband and wife in securing borrowings over the family home. There is clearly a different relationship between parties in the over-the-counter derivatives market.[79] However, the advice given by the seller of the derivative is likely to be the only advice received by the buyer; either because the seller is the 'house bank' to the buyer or is a specialist in the particular product sold preventing the client from seeking outside advice by means of confidentiality agreements. In either case, the client can properly rely on the advice that is given to them.

The finding of undue influence would, it is suggested, provide a further unjust factor to found a claim in restitution on the basis of the unjust enrichment of the seller. Where the seller profits from some unconscionable pressure on the client, those profits would constitute an unjust enrichment at the expense of the buyer, remediable by some restitutionary response. The appropriate response to remedy the enrichment would be a proprietary claim to recover the full amount of gain made and to account for the full, potential loss to the buyer connected with the seller's use of the property.

What is the appropriate mistake in cases of mistake of law?

One of the difficulties which arose in the *Islington* litigation was establishing precisely the unjust factor which would found the claim for restitution of money had and received. The change introduced by *Lincoln* is to add to the canon the most obvious

[76] *Woods v. Martins Bank Ltd.* [1959] 1 QB 55; *Standard Investments Ltd. v. Canadian Imperial Bank of Commerce* (1985) 22 DLR (4th) 410.
[77] *Lloyds Bank v. Bundy* [1975] QB 326; *Royal Bank of Canada v. Hinds* (1978) 88 DLR (3rd) 428.
[78] *National Westminster Bank plc v. Morgan* [1985] AC 686; *Barclay's Bank v. O'Brien* [1993] 3 WLR 786; *CIBC v. Pitt* [1993] 3 WLR 786.
[79] With the exception of some occasional retail business done with the private clients of investment banks.

unjust factor on the facts in the form of mistake of law. However, there is a necessary element missing from the House of Lords' decision - what is the definition of a mistake capable of invoking this principle? In considering the breadth of the test for mistake, the issue arises whether one ought to be able to include being badly advised by one's lawyers that the law does, or does not, permit a course of action. Similarly, must the mistake relate only to capacity and ability to contract, or could it be said to be a mistake of law as to the tax law impact of a transaction for one or other of the parties?

It would seem unsatisfactory for Party A to be robbed of the benefits of a transaction entered into bona fide by A, simply on the ground that Party B had been negligently advised as to the tax impact of the transaction. To permit B to claim restitution in such circumstances would have two effects: first, it gives B a form of option to terminate the agreement which would have required a very different pricing structure for a derivative product if the parties had intended to create it, and, second, it introduces a level of uncertainty into contractual dealings where otherwise valid contracts might be avoided on grounds of some unanticipated inconvenience to one or other of the parties.

A new test of suitability

The following proposition are submitted on the basis of an analysis of the preceding discussion. In considering commercial situations, the appropriate rules of equity should allocate a proprietary right to the claimant as follows. First, where the contractual agreement between the parties allocates title to the property transferred under the transaction, and that allocation is intended to apply even in the event of contract failure. Second, if the parties were of unequal bargaining strength, the product or service provided by the stronger party was provided in a context where the buyer would normally rely on the advice of the seller and the circumstance would give rise to a relationship of undue influence or fiduciary obligation on the part of the seller. Third, if a risk was allocated between the parties, where as a result of some unjust factor, either party was caused to be unjustly enriched at the expense of the other party. Fourth, if rescission is the appropriate remedy under a physically-settled transaction,[80] where the traceable proceeds of the original transfer remain in the hands of the recipient. Fifth, if the award of a proprietary remedy would accord with the common intention of the parties set out in an agreement between the parties.

Alternatively, a remedy by means of equitable compensation, perhaps by imposition of personal liability under constructive trust, should be made available to a party where a transaction is terminated in the following circumstances. First, if a risk was not assumed by either party, and as a result of some unjust factor either party was unjustly enriched at the expense of the other party. Second, if a risk was taken by either party, that risk was a reckless risk for that party to have taken in that context.[81] Third, if the parties were of unequal bargaining strength, and the product or service provided by the

[80] That is, a transaction requiring the delivery or transfer of some specific security, commodity or property other than cash.
[81] As suggested in *Royal Brunei Airlines v. Tan* [1995] 2 AC 378.

stronger party was not suitable for the purposes of the weaker party in the context of that transaction. Fourth, if rescission is the appropriate remedy under a cash-settled transaction. Fifth, 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.

Conclusions: banking practice and the law of restitution

Understanding the commercial concern

The *Islington* litigation has generated enormous concern among commercial people.[82] At one level that concern is simply grounded in the fact that the banks did not get the proprietary remedies or compound interest that 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 local authority 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 standardised documentation.

Who makes the law of finance?

One further issue which arises in *Lincoln* is as to the role of the lawyer who provides advice. The swaps markets are a good example of a situation in which there is a good deal more law settled between parties and by their legal advisers, than is decided by the courts. There is a tendency then for these lawyers to "make law" in that the market follows the opinions of these lawyers. As Lord Goff held, the markets had proceeded to do business with local authorities on the basis of "assumption … based on practical grounds, rather than on advice about the legal position".[83] The opinions of those lawyers typically support the legal validity of market practice - or, even to the extent that they raise caveats, they are read with blinkers so as to appear wholly supportive of market practice.

The other problem which arises is the situation created in which sections of the market are sealing themselves off from the operation of law so that the law under which they operate is entirely their own law. These markets operate as an autopoietically-closed system[84] into which there are not inputs from mainstream jurisprudence until a non-

[82] This is recognised by Lord Goff, Lord Browne-Wilkinson and Lord Woolf in *Islington.*
[83] [1998] 4 All ER 513, at 539.
[84] See generally Teubner, *Law as an Autopoietic System* (Oxford, 1994).

market player, such as a local authority, refuses to sign up to the prevailing orthodoxy and insists on outsiders in courtrooms sitting in judgement on financial innovation.

Risk, money and rights in property

The three elements of risk, money and taking rights in property are at the heart of all financial transactions and yet they are three of the most difficult concepts to accommodate in modern equity.

Looking first at risk, 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 litmus 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'.[85] 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.[86]

The question is then the role of risk in deciding the allocation of proprietary and personal rights. 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.[87]

The concept of money itself continues to be difficult in English law. Apart from the difficulty of conceiving of money as being a physical chattel in all cases,[88] 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.[89]

Contracts surrounding money held in electronic bank accounts ought to conceive of property rights in terms of rights between individuals rather than as full rights *in rem*.[90] 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,

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[85] See for example *Royal Brunei Airlines v. Tan* [1995] 2 AC 378.
[86] See Hoffmann LJ in *Bartlett v. Barclays Bank* [1980] Ch 515.
[87] The other party would simply need to re-price the transaction to absorb its own potential liability.
[88] As Lord Browne-Wilkinson does in *Islington* with his focus on the stolen bag of coins" as his beginning to the possibility of tracing money in the form of electronic funds transfers.
[89] Mann, *The Legal Aspect of Money*, 5th edn. (Oxford, 1992), generally; Hudson, *Swaps, Restitution and Trusts* (op cit.), Chapter 4, "the Legal Concept of Money".
[90] An issue explored in Eleftheriadis, 'The Analysis of Property Rights' (1996) OJLS 31; discussing the ideas of Hohfeld, *Fundamental Legal Conceptions As Applied in Judicial Reasoning*, ed. Cook (1923).

they are intangible property, being mere 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. The issue for a proprietary remedy is the nature of the obligation to pay. 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. 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' in the terms usually accepted by equity.

What is left from the *Islington* decision is the impossibility for commercial parties in taking security interests or creating termination structures in the event that there contracts are held to have been void. It is suggested that such risk management provisions in commercial contracts ought to be supported by the courts on the basis of common intention, to prevent undue influence, or by means of severance, unless to do so would offend against a principle of public policy.

A lesson for commercial equity

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*,[91] the test for dishonesty in *Tan*[92] and the drift of common intention constructive trusts cases like *Lloyds Bank v. Rosset*[93] in the speech of Lord Bridge, have seen a solidifying of the techniques of equity into hard and fast rules.[94] While common law torts such as negligence appear to be relaxing,[95] equity is moving in the opposite direction. As such it is proposed that the suitability approach outlined above is consistent with this reformulation of the principles of equity.

[91] [1996] AC 669.
[92] [1995] 2 AC 378.
[93] [1991] 1 AC 107.
[94] This trend is also observable in *Target Holdings v. Redferns* [1996] 1 AC 421, [1995] 3 WLR 352, [1995] 3 All ER 785 and *Barclay's Bank v. O'Brien* [1993] 3 WLR 786.
[95] *Caparo v. Dickman* [1990] 2 AC 605.