Assessing mistake of law in derivatives transactions

Kleinwort Benson v. Lincoln City Council and the local authority swaps cases (1999)

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The local authority swaps cases have been fertile ground for banking lawyers over recent years. The most distressing feature of the local authority swaps cases for the banking law community is the slight effect those cases have had on market practice in relation to established derivatives, such as interest rate swaps, and newer products, such as credit derivatives. The most recent decision to emerge from the House of Lords in the local authority swaps cases saga is *Kleinwort Benson v. Lincoln City Council* ("*Lincoln*"),[1] a case which has created sufficient interest to raise an oblique mention on Radio Four's *Today* programme.[2] This fame is predicated on the basis that the long-standing rule against restitution on grounds of mistake of law has been abolished.

Consequently, it is to be expected that there will be a detailed exposition by the restitution, contract and other cadres of lawyers as to the ramifications for their fields of endeavour which result from pleading a mistake of law to achieve restitution of money. The slightly more limited focus of this article is on the impact specifically for banking lawyers in assimilating this decision to the raft of caselaw relating to the interest rate swap.

A large amount has already been written about the problems of restitution in cases of payment under void transactions,[3] problems of terminating transactions,[4] problems associated with the liability of sellers of financial products,[5] and problems with the interpretation of the very nature of complex financial products.[6] This article seeks to consider the extra dimension added to those discussions by this new decision.

Adding to the canon of "derivatives law"

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[1] [1998] 4 All E.R. 513.
[2] Thursday 12th November 1998.
[3] Hudson, *The Law on Financial Derivatives* (2nd edn., London, Sweet & Maxwell, 1998), 203-253; Hudson, *Swaps, Restitution and Trusts* (London, Sweet & Maxwell, 1998), 64-229; .
[4] Burrows, "Public Authorities, Ultra Vires and Restitution", in Burrows ed., *Essays in the Law of Restitution* (Oxford, 1991); Hudson, (1998: 1), 203 *et* seq; Grantham, "Doctrinal Bases for the Recognition of Proprietary Rights" (1996) O.J.L.S. 561.
[5] Hudson, (1998: 1), 168-203, and see also Hudson, ed., *Credit Derivatives: Law, Regulation and Accounting Issues* (London, Sweet & Maxwell, 1999 projected).
[6] Wood, *Title Finance, Derivatives, Securitisations, Set-off and Netting* (Sweet & Maxwell, 1995); Hudson, (1998: 1), 7-148; Hudson, (1998: 2), 1-64; Das, *Swaps and Derivative Financing*, 2nd ed. (Irwin, 1994).

Much of the recent literature has focused on the case of *Westdeutsche Landesbank v. Islington L.B.C.*[7] and its ramifications for the swaps markets.[8] Much of this writer's analysis advances the thesis that claims in relation to restitution of money arising in relation to financial transactions ought to be founded on a notion of suitability.[9] The aim of this article is to take account of the House of Lords' decision in *Lincoln*[10] and the few changes it makes to the law as recounted in the remainder of this article and also its impact on the development of the law relating to restitution of money transferred in commercial transactions. As Burrows has said "it is no exaggeration to say that one could write a article on the restitutionary consequences of the decision in *Hazell's* case'.[11] As Lord Goff feared, such any book will grow in length as a result of this addition to the caselaw. There is much to say and I demur from even attempting to say it all in such narrow compass.

In looking at this new decision in *Lincoln C.C.* there is a feeling that it marks a significant development in the emerging principle of restitution on grounds of unjust enrichment in English law. The point is made later in this article that the detail of the speeches in *Westdeutsche Landesbank v. Islington* ("*Islington*") disclosed a conflict between a traditional trusts lawyers' approach to matters of restitution, which is ideologically opposed to the newer thinking based on reversing unjust enrichment. That battle is re-fought in *Lincoln C.C.*, this time with Lord Goff speaking for the majority and Lord Browne-Wilkinson asserting a strong dissenting judgement.

The facts in *Lincoln C.C.* are those common to the local authority swaps cases[12] taken on direct appeal from Langley J..[13] The facts arose out of the attempt by the bank to recover moneys paid to the respondent local authorities under interest rate swap agreements. The claim for such recovery was based on a contention that those payments had been made under a mistake of law. The mistake of law claimed was as to the capacity of local authorities to enter into such agreements. That local authorities did not have that capacity was subsequently denied by the House of Lords in *Hazell.* There were two important issues considered by the House of Lords in *Lincoln C.C.*: first, whether a plaintiff can rely on a mistake of law to found a claim for restitution, and, second, whether there ought to be any distinction in restitutionary terms between part-performed and fully-performed transactions.

The majority decision in Lincoln C.C.

Two issues arose on the *Lincoln C.C.* appeal: first, whether the mistake of law rule ought to be abolished subject to two defences where that mistake is based on (a) a settled understanding of the law or (b) honest receipt of money by the payee; and,

[7] [1996] A.C. 669; see Birks, 'Trusts raised to avoid unjust enrichment: the *Westdeutsche* Case' [1996] R.L.R. 3; Worthington, *Proprietary Interests in Commercial Transactions* (Oxford, 1996).
[8] Hudson, (1998: 1).
[9] Hudson, (1998: 2), 196-229.
[10] [1998] 4 All E.R. 513.
[11] Burrows, "Swaps and the friction between common law and equity", [1995] RLR 15.
[12] See perhaps McKendrick 'Local Authorities and Swaps: Undermining the Market?' in *Making Commercial Law: Essays in Honour of Roy Goode,* ed. Cranston (Oxford, 1997)
[13] Hudson, (1998: 2), 9 *et seq.*

second, whether the Limitation Act 1980 could be prayed in aid in respect of the time at which such mistake was uncovered. Only the first issue is considered here.

Lord Goff, speaking for the majority, held as follows:

1. the rule that there could be no restitution of money paid under a mistake of law would no longer form a part of English law;
2. it is not a part of English law that payments made under a settled understanding of the law among market participants, which is subsequently departed from by judicial decision, is irrecoverable by restitution on grounds of mistake of law;
3. there is no defence at English law of honest receipt by a payee to an action for restitution based on mistake of law; and
4. there is no principle that money paid under a contract void an initio is irrecoverable because the contract had been fully performed before the contract was declared, or understood to be, void.

The logic, and shortcomings, in the dissenting position

The powerful central point made by Lord Browne-Wilkinson in his dissenting speech is that at the time of the payments made under the swaps transactions, it was a settled analysis of the then existing law that local authorities could enter into the swaps transactions. Therefore, it was said that there was no operative mistake on the minds of the banks. Rather, the banks were proceeding on the basis of an understanding of the law *at that time.* Lord Browne-Wilkinson rejects the proposition that there can be retrospective mistake of law activated by a subsequent change in the law. In his lordship's view the parties to a contract ought to be able to rely on there being closure of their contractual arrangements such that subsequent judicial decisions ought to have no place. The risks for contracting parties is that no transaction will ever be capable of being deemed complete on the basis that a subsequent change in the law may yet caused it to be declared void. Therefore, the law was created, in Lord Browne-Wilkinson's terms, in 1991 with the decision in *Hazell.* Lord Goff takes the opposite view that the role of the court is to declare what the law has always been; i.e. at the time when the contracts were created pre-*Hazell*.

This writer cannot agree with Lord Browne-Wilkinson's position that there was in logic no mistake, neither in relation to local authority interest rate swaps nor in general terms. The banks were under the impression that local authorities could enter into the transactions whereas, as the House of Lords declared in *Hazell*, local authorities could not enter into such transactions. The operative mistake in the local authority swaps cases was not based on law settled by a court but rather on a mistaken assumption among the swaps community as to the capacity of local authorities to enter into interest rate swaps in relation to what a court *would say if it were ever appraised of the issue at some time in the future*. The House of Lords in *Hazell* were not saying that there had been new events or new legislative intervention which meant, for the first time, that local authorities could not enter into such transactions. Rather, the House of Lords was declaring that local authorities *had never had capacity* to enter into such transactions. Therefore, the banks *had been* operating under a mistake on entering into the transactions.

The House of Lords considered the possibility of a claimant relying on a perception of "settled law" to found an action on mistake of law. Quoting Lord Denning, Lord Browne-Wilkinson found that "[t]he practice of the profession in these cases is the best evidence of what the law is - indeed it makes the law". The disturbing ramifications of market practice making law are considered below. The question will always be whether or not there is sufficient agreement in the market as to suggest that there is a clear view of the law. Given the troubled state of the law relating to derivatives in the wake of decisions like that in *Islington*, and the very disturbing pattern of slavish reliance on the terms of standard market contracts (which were designed in any event to be modified on a case-by-case basis), it is at least unlikely whether there could be said to be settled opinion in any event. It is something to be grateful for that the court decided that reliance on a settled view of the law would found a claim based on mistake of law.

The context of risk

To disallow the parties from relying on restitution on grounds of mistake of law disables the parties from relying on the risk allocation provisions in their contracts. This arguments enters us onto the roundabout considered below that, if it was *ultra vires* the local authorities entering into the interest rate swap, there can be no argument that there was any contract in the first place. This argument is countered in this article by saying that it ought to have been open to the parties to rely on the doctrine of severance to preserve their risk allocation decisions, and that the doctrine of common intention constructive trust ought to be employed to impose an equity on both parties to respect those risk allocation and security provisions.[14] Failure to recognise such provisions increases systemic risk in financial markets and makes the conduct of global financial business both more complex and riskier (that is, for economies involved as well as for the financial institutions).

What is the test for this mistake of law?

There is a necessary element missing from the House of Lords' decision - what is the appropriate measure of a mistake suitable for invoking this principle? In other words, should the plaintiff be entitled to rely on a mistake of law in all cases where the lawyer considers the law to be *x*, when it is in fact *y* according to a subsequent decision of a court. 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 obtain 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 fides by A, simply on grounds that Party B had been negligently

[14] See the extended discussion in Hudson (1998: 2), 198-229.

advised as to the tax impact of the transaction. To permit B to rescind the contract in such circumstances would have two effects: first, it gives B an option to terminate which would have required a very different pricing structure for a derivative product, 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.

If the categories of acceptable mistake are to be limited, there is a need for better guidance. It might be that legal incapacity is the sole category of suitable mistake. However, there are further issues as to the regulatory classification of transactions which may run to incapacity, or may simply impose an unexpected cost on the parties. Fundamentally, the issue must revolve around whether or not the mistake is mutual or simply unilateral. Unilateral mistake clearly offers greater potential for unfairness between contracting parties, whereas mutual mistake offers both parties reason for rescinding their agreement.

The clearest advice for contracting parties in financial contracts is to include in their agreements, their conduct of business documentation, and their transaction confirmations, some statement as to the expectations of the parties on entering into the transaction. The point is made in this article and in *The Law on Financial Derivatives* that standard market contracts are not sufficient in their current form to make sufficient statement as to the parties' underlying intention and to make plain those factors which are operative on the parties in creating (or in purporting to create) contracts.

There are only brief clues in the speeches as to the factors which may and may not be taken into account. In overruling the mistake of law rule, Lord Goff considers[15] the words of Sir William Evans's, author of the "Essay on the action for money had and received"[16] which first criticised the mistake of law concept, where he said:

> "… no man shall, under the pretence of ignorance of the law, excuse himself from the performance of his own obligations, or acquire an advantage, or avoid a detriment, when he has omitted using the means ordained by law for those purposes."

It is suggested that this goes only part way towards answering the question "what will found a mistake of law?". Lord Hoffmann considered, in outline, the nature of mistake and expressed reservations about "a robust, commonsense definition of a mistake" which would not account satisfactorily for Lord Browne-Wilkinson's difficulties with retrospectivity.[17] The question turns, in his lordship's view, on whether or not it was possible to ascertain the truth or falsity of any proposition. This itself begs the question as to the forms of proposition which are material.

[15] [1998] 4 All E.R. 513, 527.
[16] Published originally in 1802 but reproduced at [1998] RLR 1.
[17] [1998] 4 All E.R. 513, 552.

Inadequacy in assessing risk allocation between the parties

As considered in detail in the subsequent text,[18] the point which is not given much attention in any of the local authority swaps cases is that the swaps documentation signed by the parties provided expressly for a representation that both parties have the capacity to enter into the contract and to perform all their obligations under the contract.[19] Where this representation fails, the contracts provided that a failure in respect of such a representation is an event of default under the contract, leading to a right in the non-defaulting party to termination. In *Islington,* Hobhouse J. was alone among the judges who heard the *Islington* litigation in addressing the point in the context of the doctrine of mistake between the parties as to the capacity of one of them.[20] He found '[t]here is no evidence or allegation in either case that the relevant bank was mistaken as to any actual fact.'[21] However, he did find that there had been a mistake as to the local authorities' capacity to perform under the swaps contracts. It was said that that mistake as to capacity stemmed from a mistake as to the interpretation of the Local Government Act 1972.

As set out above, what remains unclear as a result of *Lincoln C.C.* is the issue as to *what exactly constitutes a mistake* and whether risk allocation provisions could play any part in this. There is, for example, a distinction between an *assumption* that something is the case and a *mistake* as to whether or not something is the case. The view propounded by Hobhouse J. in *Islington* would seem to suggest that that was not a case involving a mistake because the parties were acting on an assumption as to the validity of their contracts. This assumption view suggests that the risk was not considered and therefore was not, in any sense, an active factor which impacted on the parties. As considered elsewhere in this article, that view is in any event unsatisfactory in that it fails to acknowledge that in all the local authority swaps cases the documentation effected between the parties constituted an explicit assessment of the risks of such incapacity. It is not clear therefore the nature of the mistake which can be relied upon.

The primary submission for the banks in *Islington* at first instance was that there were mistakes of fact operating on the mind of their employees in dealing with the local authorities: specifically, that they thought local authorities were capable of entering into swaps agreements. Hobhouse J decided from the outset that he would not consider questions relating to the state of mind, nor any possible mistake in the mind, of the employees of the banks. Therefore, the issue of mistake was rapidly dismissed.[22] The courts' determination to ignore the substantive terms of the agreements mean that the parties are not able to allocate risks, nor is the market able to control the systemic risks in the derivatives marketplace. [23] Were it definitively the case that netting or hedging arrangements could never be included, at law or equity, as

[18] See in particular Hudson, (1998: 2), 63 *et seq.*
[19] As discussed above in chapter 4, this provision is common to the ISDA terms and also to the BBAIRS terms for swaps and OTC derivatives dealings more generally.
[20] [1994] 4 All E.R. 890, 931.
[21] *Ibid*.
[22] [1994] 4 All E.R. 890, 905, Hobhouse J.
[23] See Hudson, (1998: 2), 78 *et seq*.

being within the contemplation of the parties, then this would have included some acknowledgement of the contractual intentions of the parties.

The role of the advising lawyer

The 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. Celebrated firms of solicitors, eminent barristers, and laudable trade organisations (like the International Swaps and Derivatives Association ("ISDA"), the Financial Law Panel and the British Bankers' Association ("BBA")) continue to attempt to isolate and resolve the vast majority of problems which are thrown up by the products generated by commercial parties.

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".[24] 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. This, beyond mere cynicism on the part of this writer, is a pernicious, lazy and downright dangerous practice. There is a tendency within the financial institutions themselves to ignore potentially real problems. In this writer's view, in such situations, banks are not operating under mistake of law, rather they are rightly victims of their own sloppy business practices in failing to isolate and examine all the applicable legal risks. For them, the urge to make money is irresistible: the management of risk is a cost that is to be controlled like other costs.

The other problem which arises from this is more academic perhaps: in short, is a 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[25] into which there are not inputs from mainstream jurisprudence until a non-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. This is always a risk - like other risks it can be measure and managed. The derivatives markets are beginning to mature. Their legal analysis and legal practice must similarly mature.

Broader themes

The main concern of the restitution lawyer, within its central remit of analysing the development of the law of restitution in the banking context, is to highlight three key issues arising from the *Islington* and *Lincoln* litigation. First, that the courts failed to

[24] [1998] 4 All E.R. 513, at 539.
[25] Teubner, *Law as an Autopoietic System* (Oxford, 1994).

take into account the nature of swaps and their necessary allocation of risks between counterparties. Second, the problems created for the law of restitution by English law's conception of money as tangible property rather than as intangible choses in action held in electronic accounts. Third, the problem of taking security in financial transactions as a result of the decision of the House of Lords and by using standard market contracts as currently constituted.

The underlying theme of the article, then, is the conflict between the attitudes of traditional trusts lawyers and the proponents of the emerging principle of restitution of unjust enrichment. The article sets out new models for problems of equitable proprietary claims and unjust enrichment claims based on suitability for future cases, based on existing caselaw and by employing other techniques such as common intention constructive trusts, the doctrine of severance and the doctrine of undue influence. The law relating to financial products, and in particular derivatives, requires a radical overhaul to meet the changing judicial appetite for restitution and strict liability in relation to the liability of intermediaries and fiduciaries. Amid the growing cries for different or greater regulation of derivatives markets, there is a need for the legal community which advises financial institutions to recognise the very real risks being created for the future by these seismic developments in the substantive law affecting bankers and banking transactions.