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"Seller Liability for Credit Derivatives"[1]

Alastair Hudson

Barrister
Lecturer, Queen Mary and Westfield College, University of London

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Credit derivatives are the latest star in the derivatives firmament. They combine all of the commercial strengths and weaknesses of more established products, and, because they are based on established structures, they give rise a number of similar legal issues. What is different about credit derivatives is that they involve the use of an intangible, almost chimeral, indicator (credit worth) as an underlying pricing mechanism.

This paper examines the potential liabilities which credit derivatives raise for those financial institutions which deal in them and which sell them to corporate clients. The conundrum is this. The professional adviser faces potential liability for advising a client to follow a particularly risky course of action. Therefore, the adviser will also advise the client to seek independent advice or will seek some representation as to the client's own competence to seek that advice. In the case of complex derivatives products, the details of the transaction will be secret because the pricing structure will be commercially sensitive information. Therefore, the client will not be permitted, under the terms of the transaction, to seek external advice. Even if the client were able to seek such advice, that advice would be procured from a professional adviser which would seek to install its own funding structure. Where the seller is also "house bank" to the client, that is the bank which provides most of the ordinary borrowing and other financial requirements of the client, it would be expected that the client would rely entirely on the advice given to it by the house bank.

Consequently, the seller of derivatives products will occupy a unique position in relation to the client which increases the risk of potential future liability to the client in the event that there is any loss resulting from the derivative product sold.

The nature of the credit derivative

The "credit derivative" is a collective term for a group of products which use familiar financial derivative techniques: the option, the forward and the swap. The aim of the

[1] This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).

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credit derivative is to provide the buyer with an entitlement to receive a cash flow which varies in size according to the movement in the credit worth of a "reference entity". For example, where the buyer has lent money to a reference entity, perhaps by subscribing for a public debt issue, and is concerned that a deterioration in the credit worth of the reference entity will decrease the value of its own investment, the buyer will seek a cash flow which will make good the difference between the value it would have received if the credit worth had not deteriorated and the actual value it does receive. Therefore, the credit derivative offers a neat risk management tool to preserve the effective value of an investment to the investor.

Alternatively, the credit derivative might be used for speculative purposes. Where the credit worth of a reference entity is volatile, it would be possible to receive a cash flow sensitive to the fluctuating credit worth of the reference entity but with the intention of making speculative profit on the size or direction of such a movement. The only difference between a hedging and a speculative position in this context would be the existence or non-existence of an underlying exposure to the credit worth of the reference entity which pre-dates the credit derivative.

The mechanics of the creation of the product are also significant. A number of issues arise: *calculation*, *valuation*, *materiality*, and *representations.* Many of these issues are covered in the documentation. However, all of them will be effected by the discussions between the individual trader and other agents acting on behalf of the seller and those acting on behalf of the buyer.

There are three basic structures governing the payment that is made by the seller of the derivative, subject to what is said below about each form of transaction. The first mechanism is the total return structure[2] in respect of which the seller provides the cost of funding the underlying debt obligation periodically to the buyer; the buyer pays a fixed rate periodically and on maturity of the underlying debt obligation to the seller. Typically this is a swap or embedded security structure. It is on the happening of a credit event that the seller is required to pay an agreed amount to the buyer representing the value of the underlying security. Given the use of payment netting, the seller is generally only required to make payment after a credit event.

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

Credit options

The credit option entitles the buyer to receive a one-off payment on the occurrence of some specified event which triggers payment under the option. The option may be

[2] Considered above in relation to total return swaps.

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settled either in cash or by physical delivery of a specific security. The buyer pays a premium to the seller in the ordinary way. The option becomes in-the-money in circumstances in which the underlying obligation decreases in value according to the price fixed in the option documentation. A cash-settled option then requires the seller to pay an amount of money or a physically-settled option may require the seller to deliver securities in return for the underlying obligation. As with standard option structures, the option may have an exercise period which arises within specified time periods or on a specific maturity date. The exercise mechanism may be an automatic or reliant on notification between the parties.

The buyer's right to exercise the option may arise in the event of a straightforward decline in the performance of the underlying obligation in the market beyond a level specified in the strike price of the option. In this instance a barrier structure is created whereby the option is exercisable only where that limit has been crossed. The barrier structure may also specify a further limit beyond which market movements are outwith the expectations of the parties and therefore the transaction will be deemed frustrated. However, the right to exercise may alternatively be restricted to the happening of a credit event. That credit event itself may be subject to the materiality of the credit event or the publication of information as to the condition of the underlying obligation.

Total return swaps

The credit swap provides for the seller to provide protection against the risk bound up in the buyer's exposure to the underlying obligations. In effect, as considered above, the seller provides the cost of funding the underlying debt obligation periodically to the buyer. Therefore, the seller will pay a floating rate including a contractually agreed amount on the maturity of the underlying obligation or in relation to a credit event under the transaction. Reciprocally, the buyer pays the return received by it from the underlying obligation. On the maturity of the underlying debt obligation, the buyer pays the final value on maturity to the seller.

Seller	Buyer	Underlying obligation
Seller pays floating rate linked to LIBOR plus an amount on maturity or credit event	Buyer pays floating rate plus value on maturity or credit event	Underlying obligation pays floating rate linked to LIBOR plus principal on maturity

Therefore, the swap element of the transaction relates to the exchange of cash flows between the seller and the buyer which are closely related to the return generated by the underlying obligations. The fixed rate which the buyer is effectively paying is the contractually agreed spread over the return on the underlying obligations. The position risk accepted by the parties is that a credit event is triggered which requires the seller to make a higher level of payment to the buyer: it is this contingent obligation from

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the seller which constitutes the floating rate element under the classic swap structure. It is this element which insures the buyer against a loss from the underlying obligations. Otherwise the application of payment netting between the parties will ensure that it is effectively only the cost of funding relating to the buyer's exposure to the underlying obligation until a credit event occurs. It is on the happening of a credit event that the seller is required to pay an agreed amount to the buyer representing the value of the underlying security or another amount specified in the documentation.

The swap structure, linked in nature to forward contracts, requires payment to be made in a manner which is contingent on the extent of market movements. As a result it is possible that market movements will exceed the expectations of the parties, thus requiring payment by the seller in excess of its largest expectations. A barrier structure might then be used. The inception of the requirement to make payment would arise where the barrier level of market movement or the happening of a credit event, as required by the transaction, is satisfied. Similarly, to cap the exposure of the parties, and to express their contractual expectations as to the largest possible market movements, a barrier level would then be activated to place a maximum on the size of payment made by the seller.

The aim of the credit swap is to generate reciprocal cash flows such that the buyer is paying a fixed rate spread in relation to which the seller bears the risk of paying an amount which floats according to the happening of the credit event. This is primarily attractive to the buyer who requires a cash flow return to hedge its exposure to the underlying obligations. A similar cash flow structure is generally used in relation to embedded derivatives. This fluid, cash-flow-orientated is compared with commercial situations where the buyer seeks a one-off payment under a credit option.

While the foregoing analysis considers swaps generically, the credit swap is usually structured either as a total return swap or as a credit default swap. The credit default swap aims to provide protection against credit losses associated with a default on a specified underlying obligation. The buyer swaps its credit risk on the underlying obligation with the seller, as indicated above. The buyer is therefore paying a fee in return for which the seller makes a payment on the happening of a credit event. Under a total return swap the buyer pays the seller the "total return" on the reference asset including any increase in its market value.[3] The seller is therefore paying a floating rate of interest to the buyer in return for this income stream. The "guarantee" element for the buyer arises where there is some depreciation in the market value of the asset which requires payment from the seller, on a payment netting basis.

Founding claims[4]

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[3] Thus, the seller is occasionally said to have "synthetic ownership" of the reference asset because the seller receives all the accretions and disbursements associated with absolute beneficial ownership of the reference asset from the buyer.

[4] This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).

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The nature of the credit derivative is therefore that it, in terms, provides a form of insurance policy for the buyer. However, the insurance policy only works if the derivative product performs in the manner expected by the parties. Therefore, the seller is required to make a number of representations as to the performance of the product and as to the likely credit performance of the reference entity. As highlighted above, there are four key issues with reference to a credit derivative: *calculation*, *valuation*, *materiality*, and *representations.*

The core of credit default clauses is the credit downgrade clause. In relation to master agreements, it is the credit worth of the counterparties which is at issue; in relation to a credit derivative it is the credit worth of the reference entity which is at issue.[5] Where the reference entity has its credit rating reduced by one or more recognised ratings agencies, then a credit derivative must deal with the alteration required in the payments under the derivative transaction. In the case of a barrier arrangement, for example, this may lead to the first time a payment is required from the seller.

The first issue is therefore as to *calculation* and in particular the policies of the ratings agencies which are used for the purpose of assessing the credit rating of the reference entity. There may be policies within the ratings agencies which the parties may wish to discount in the calculation of pricing structures under the agreement. Similarly, the ratings agency may alter its own policy. The credit rating may alter in relation to a corporate restructuring which the parties to the derivatives transaction may wish to attach a different weighting to that attaching to the rating agency's rating decision. Alternatively, the parties may construct their own mechanism by which the credit worth of the reference entity is to be calculated. In circumstances where the ratings agency's published downgrade might happen too far after the credit event complained of, the parties may prefer to reach their own decision. Evidently, the role of the calculation agent in respect of the credit calculation process becomes all the more important than simply in relation to the size of payments to be made between the parties.[6]

Having decided on a mechanism for calculation, the calculation agent will then be required to reach a *valuation* of the credit of the reference entity. In relation to the credit profile of the reference entity, it is assumed by the contracting parties that the reference entity will retain the same corporate structure throughout their transaction. Therefore, any events of restructuring will constitute credit events. The principle concern, relating to the credit performance of the reference entity in this context, is the impact of the credit worth of the resultant entity after the corporate restructuring. A material reduction in the credit worth would constitute a credit event. Similarly, a repudiation by the resultant entity of the contractual obligations of the former reference entity would similarly constitute a credit event.

The core of the documentation for a credit derivative is the *materiality* provision which provides that the credit downgrade in relation to the reference entity must be sufficiently material to require payment under the credit derivative itself. As part of

[5] In contracting a master agreement for a credit derivative, there may be a tier of credit worth language which relates solely to the counterparty, and not to the reference entity, in the usual way.
[6] See *Documentation: Confirmations* at 2.1 below.

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the structuring role of the seller, this provision requires the making of further representations by means of assurances as to the performance of the transaction. Furthermore, the calculation agent, typically the seller in accordance with standard market practice, will be required to assess the materiality of the alteration in credit worth. The calculation agent's own decisions as to credit, involving a necessary degree of subjectivity as to the projected cash flows of the reference entity, require the making of, in effect, ongoing representations as to the performance both of the reference entity and of the credit derivative itself.

In the context of *representation* the seller will not only represent the performance of the product in relation to the credit of the reference entity, but will also represent the suitability of the product to meet the insurance (hedging) or speculative commercial purpose of the buyer. Litigation has commenced in a number of contexts in the USA relating to the suitability of derivatives products provided by financial institutions both to corporate clients and to public authorities. In the English jurisdiction there is also now a decided case on the liability of derivatives sellers to a less experienced buyer.[7]

Classifying claims[8]

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.[9] Those claims can be analysed as falling into three categories: claims arising out of contract (consent), claims arising out of tort (wrongs), and claims arising on the basis of some unconscionable act by one or other of the parties (unjust enrichment). The tri-partite division between consent, wrongs and unjust enrichment is a modish one, commanding the particular support of restitution lawyers.[10]

The 'consent' category deals with 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. As considered in the discussion of the confirmation process in creating derivatives documentation,[11] there will be a number of situations in which there is an issue as to whether or not the parties have formed any sort of enforceable agreement, whether there is sufficient documentary evidence of such an agreement, or whether the parties have reached agreement on all the terms which were vital to the formation of a viable contract. Claims based on this category would therefore 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.

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[7] See the discussion of *Bankers Trust International PLC v. PT Dharmala Sakti Sejahtera* [1996] CLC 518, below.

[8] This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).

[9] See perhaps Cranston, "Banks, Liability and Risk", in *Banks, Liability and Risk*, Cranston ed. (Lloyds of London Press, 1995), 1-14.

[10] See perhaps Birks, 'Trusts Raised to Reverse Unjust Enrichment: The *Westdeutsche* Case' [1996] RLR 3, 26.

[11] *Documentation*, Chapter 2.

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There is a link with 'suitability' as to the appropriateness, enforceability and the availability of claims arising out of the law of contract. For the most part, claims based on consent will tend to settle in the marketplace, unless one of the parties has become insolvent. Where transactions are cash-settled the parties will tend to come to some accommodation as to an amount which would settle their differences. This is particularly the case between financial institutions. Rather than suffer the legal cost of litigation and the reputation cost of unperformed transactions, most market counterparties will tend to opt for settlement. In situations involving non-market users of the products, such as local authorities, the scope for litigation is greater. In particular, market-makers in derivatives products will tend to favour the implementation of their contractually agreed means of termination and settlement, or to rely on market standard procedures (principally because the standard market forms of settlement were agreed between the financial institutions under the ISDA umbrella in any event).

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.[12] The wrong complained of might fall into one of a number of factual categories:-

(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.

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 issues of mistake, whether mistakes of law or fact,[13] form part of the law of contract or unjust enrichment depending on the circumstance.[14]

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[12] As in the best known of the US cases in this area: *The Proctor and Gamble Company v. Bankers Trust Company and BT Securities Corp.*, Civil Action No. C-1-94-735 (S.D. Ohio) and in England the decision in *Bankers Trust International PLC v. PT Dharmala Sakti Sejahtera* [1996] CLC 518.

[13] It is accepted that English law does not currently accept the possibility of an action for mistake of law (*Bilbie v. Lumley* (1802) 2 East 469) although a large body of academic commentary and judicial obiter dicta suggest that the principle may yet be overturned: *Woolwich Equitable Building Society v. Inland*

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The claim in unjust enrichment[15] would be a claim mounted on any one or more of the following factual bases:-

(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; 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 - particularly in the light of the attitude of the majority of the House of Lords in *Westdeutsche Landesbank v. Islington*.[16] 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;[17] to the trusts lawyer it is the assertion of a common law or equitable tracing claim against that property.[18]

The category 'unjust enrichment' is therefore intended to cover the broad range of equitable claims and those restitutionary claims which are concerned with the buyer of a derivative seeking to recover property or value from the seller of that derivative. Thus, classes 1 and 2 above refer to the recovery of some specific property from the seller, where that seller or some other person has been enriched by the receipt of property from the buyer in connection with the unsuitable provision of that financial derivative. Classes 3 and 4 refer to some unconscionable act on the part of the seller or some other person which results in an award of monetary compensation or the imposition of financial obligations based on constructive trusteeship.

In attempting to reach a catch-all standard for claims in this area, a test of "Suitability", it is submitted, would be the most apposite. "Suitability" is described by

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Revenue Commissioners [1993] AC 70, 154, 199 *per* Lord Keith and Lord Slynn; *Restitution: Mistakes of Law and Ultra Vires Public Authority Receipts and Payments* (1994), Law Comm. No. 227; Beatson [1995] RLR 280; 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; .

[14] And also the reader's point of view about the ubiquity of the law of restitution.

[15] The term "law of unjust enrichment" is preferred to "law of restitution" in the wake of the House of Lords' decision in *Lipkin Gorman v. Karpnale* [1991] 2 AC 548.

[16] [1996] AC 669.

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

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

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some of the commentators as an 'emerging standard'[19] derived from US financial regulation and as emerging from UK regulation.[20] In the Conduct of Investment Business rules there is specific mention of suitability. The SIB's conduct of business rules[21] deal with derivative transactions under which private customers have a contingent liability to make payments at some time in the future, there is a requirement that a two-way customer agreement is put in place. 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.

Suitability as considered in the context of this section is in the form of the collective term for a group of common law, statutory and equitable claims to do with the liability of the derivatives dealer. There has been some debate as to the need for a concept of suitability within the English common law to protect unsophisticated users of financial derivatives from the dangers inherent in the products and also to protect them from the attentions of experienced sellers.[22] Much of the argument circulates around the issues which typically arise in the debate as to the need to regulate financial derivatives because they are risk-laden time-bombs in the hands of the unwary. The principle argument for the development of a distinct category of liability on grounds of suitability is that derivatives constitute a new risk which is deserving of a specific, tailor-made remedy. The counter-argument is that there is a sufficiency of common law and equity able to deal with these claims.[23] This argument is capable, at its edges, of running into the anti-regulation argument that existing regulatory safeguards ought to be sufficient to protect the unwise or unwary on entering into derivatives agreements.[24]

The other sense in which the term "suitability" is frequently used in the financial services context is in the regulatory field. As a point of re-emphasis, the point of view of this section is that English law does have enough common law and equitable forms of action to cater for the needs of the inexperienced buyer - but that the term "suitability" is a useful collective term for their application and motivation in this context.

Derivatives dealer liability under English law[25]

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[19] Cranston, *Principles of Banking Law* (Oxford, 1997), 212.

[20] See Blair, *Financial Services: The New Core Rules* (Blackstone, 1991), 94.

[21] SIB Rules, Ch. III, Pt. 2.

[22] E.g.: Greene, "Suitability and the Emperor's new clothes" (1996) 3 EFSL 53; and Little, "Suitability the Courts and the Code" (1996) 3 EFSL 119.

[23] See especially Greene, *op cit.*.

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[25] This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).

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In the context of derivatives there has been one reported decision which has considered the specific liability of the sellers of financial derivatives in the decision of Mance J. in the case of *Dharmala*.[26] This case summarises precisely the issues which are specific to the selling of financial derivatives in general and interest rate swaps in particular.[27]

There are indications in the judgement that the relationship between the parties is of a particular nature that it needs to be considered on its own facts. By extension then, the circumstances of all sellers and buyers of financial derivatives need to be considered on their own facts. In particular Mance J. held that not all statements made by BT are necessarily to be considered to representations if DSS is to be expected to exercise its own skill and judgement as to that statement. To this extent the Bank of England's London Code[28] is cited with approval in its approach to each individual client and an evaluation of that client's level of knowledge and expertise in the requisite field.

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

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

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

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

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

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Dealers' representations[29]

In the context of a financial derivative product, it is the uncertainty of future market movement that forms the rationale for the entire transaction. That is so whether the transaction is constructed around speculative gain or prudent risk management. There are two potential categories of issue: resultant loss caused by unanticipated movements in market rates ('*failure of model*') and loss caused by a reckless level of risk being taken by the buyer on the advice of the seller ('*suitability failure*').[30] In the context of "failure of model" the allocation of risks lies with the advisor in seeking to match market volatility with the forecasts and assessments set out in the pricing model. Failure to anticipate all of the resultant movements may, of course, stem straightforwardly from negligence and thereby be actionable in tort. The issue would arise as to the foreseeability of the loss actually suffered. Alternatively, the buyer could seek restitution on the basis of a failure of basis: that is, the movement of the appropriate markets in a way and to an extent which the parties had not expected. In reference to options on equity markets, for example, it would be advantageous to the commercial parties to specify a maximum volatility which they anticipate in the market, such that excess volatility (outside their expectations or common intentions) would be discounted. It is submitted that volatility outwith those boundaries would give rise to a claim founded on failure of basis.

The claim based on "suitability failure" would arise where the risk which the buyer sought to manage was not met by the risk inherent in the product bought. For example, the use of an interest rate swap which did not pay an interest rate to the buyer equivalent to the size of risk inherent in its existing debt portfolio (a rate equal to x), but rather one which contained an element of speculation (thus specifying a rate equal to $x+ y$). The element that equalled y would be unnecessary for the purposes of debt management. The factor to be proved by the buyer claiming suitability failure would be that the element y constituted an unsuitable addition of risk which went beyond the basis upon which the transaction was created. It may be that the element y arises from market disruption which the parties had not foreseen but which was not covered by the contract. Alternatively, y might be an element which was knowingly added to the transaction but which constituted an unacceptable increase in the risk incumbent on the buyer.[31]

As considered with reference to the *Dharmala* case above,[32] the issue of undue influence may also turn on the relationship between the buyer and the seller. In

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[29] This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).
[30] At this level there is a potential claim, as considered above with reference to reckless risk-taking.
[31] It was this latter, factual category which founded Proctor and Gamble's claim against Bankers Trust in relation to a claim for a loss of approximately US$160m caused by the selling of 'high octane swaps' for the corporate party's debt management which had an in-built exposure to speculative movements in the underlying markets. The corporate party brought the action on the basis of the bank's allegedly negligent advice in selling the product without recognising its unsuitability both for the purpose and the particular buyer.
[32] At 5.3.

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circumstances where the buyer would typically rely on the seller for advice without recourse to any other expert, perhaps as its house bank which provided all its finance requirements, and where the client has no particular financial expertise of its own, the seller must be particularly careful in marketing complex products. In *Dharmala* itself, DSS argued that BT owed it a duty to suggest more straightforward products which would have achieved its objectives. Mance J. found that DSS had been involved in and eager for the particular product created. However, where a more risky and complex product is foisted on the buyer by the seller, in circumstances where vanilla, less risky products would have achieved the same goals, it is suggested that the seller is at risk of a claim for undue influence brought by the buyer.

A claim for undue influence, if successful, permits the victim to set aside the transaction which has been created as a result of that undue influence.[33] This action is categorised as a form of "constructive fraud".[34] The victim will be able to set aside a transaction on the basis that there has been some form of undue influence but not as a means of protecting itself from the result of its own folly or failure to act.[35] Furthermore, the victim will not be able to establish undue influence simply because there is inequality of bargaining power between transacting parties; rather, the buyer must show some undue influence over and above that.[36]

The issue is this: if equity will respond to a fiduciary who takes unacceptable levels of risk with the trust fund, what is it that will lead to a person being made a fiduciary? IN a fiduciary relationship[37] although, it is suggested, there are circumstances in which the advising seller so inter-meddles with the affairs and risk management objectives of the buyer that the seller must come to occupy a fiduciary relationship in respect of its counterparty and client.[38]

The role of the equitable doctrines of undue influence, constructive trusts to give effect to the settlor's intentions and of common intention constructive trusts, were not issues raised by Lord Browne-Wilkinson in *Islington*.[39] In *Barclays Bank v. O'Brien*[40] the House of Lords established the need to take independent advice. The issue arises then: what advice will dispel the undue influence? Further to *Credit Lyonnais v. Burch*,[41] it is not clear whether there is the possibility of undue influence in OTC

[33] *Allcard v. Skinner* (1887) 36 ChD 145; *National Westminster Bank v. Morgan* [1985] AC 686; *Barclays Bank v. O'Brien* [1994] 1 AC 180; *TSB Bank v. Camfield* [1995] 1 All ER 951.
[34] See *Snell's Equity*, 29th edn. (Sweet & Maxwell, 1990), 550.
[35] *Tufton v. Sperni* [1952] 2 TLR 516.
[36] *National Westminster Bank v. Morgan* [1985] AC 686; although it is perhaps unclear how this doctrine is to be applied in the wake of *O'Brien*.
[37] *National Westminster Bank v. Morgan* [1985] AC 686.
[38] *Lloyds Bank v, Bundy* [1975] QB 326, a decision which concerned advice given by a bank to an old man who relied entirely on the advice of the bank's manager: cf: *National Westminster Bank v. Morgan* [1985] AC 686..
[39] [1996] AC 669.
[40] [1994] 1994] 1 AC 180, [1993] 3 WLR 786.
[41] [1997] 1 All ER 144. See also *Barclays Bank v. O'Brien* [1994] 1 AC 180; *CIBC Mortgages v. Pitt* [1994] 1 AC 200; *Massey v. Midland Bank* [1995] 1 All E.R. 929; *Midland Bank v. Serter* [1995] 1 All E.R. 929; *Bank of Boroda v. Reyerel* [1995] 2 F.L.R. 376; *Banco Exterior Internacional v. Mann* [1995] 1 All ER 936; *Halifax Mortgage Services Ltd. v. Stepsky* [1996] Ch. 1; [1995] 4 All ER 656; *Banco Exterior International SA v. Thomas* [1997] 1 WLR 221; [1997] 1 All ER 46; *Barclays Bank v. Thomson* [1997] 4 All E.R. 816.

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derivatives market or whether these multinational organisations are simply arm's length parties. The decision in *O'Brien*[42] as to the application of the principle of undue influence in the provision of guarantees in respect of domestic mortgages, could be extended to cases of commercial guarantees or collateral agreements which are obtained in respect of derivatives transactions. It is possible to argue that *O'Brien*[43] is a decision which is also about risk allocation. In compiling a test for equity in commercial situations, a test of 'commercially acceptable conduct' may be better than 'unconscionable conduct'. As with *Tan*,[44] there would be an establishment of an objective standard of probity.

Conclusions: private law as regulation[45]

Much of the US litigation has failed to reach any judicial resolution because the parties settled in advance of full trial.[46] Therefore, it is difficult to make any detailed comparisons. The main litigation in the USA has concerned large corporate entities claiming exploitation by financial institutions, *Gibson Greetings v. Bankers Trust Co.*[47] and *Proctor and Gamble v. Bankers Trust Co.*,[48] or in relation to the powers of local authorities, *Orange County Investment Pool v. Merrill Lynch & Co.*,[49] and *State of West Virginia v. Morgan Stanley & Co. Inc.*,[50] among others.[51] Where there is an interesting overlap to observe is in the emergence of suitability as a concept within SFA regulation in the UK[52] akin to the concept of suitability within US regulatory regimes.[53] In the US litigation, "suitability" emerged as a concept by which the liability of the seller could be measured. Therefore, it crossed into substantive legal claims rather than remaining solely applicable to regulatory rules.

The suitability claim in this context is said to fall into two forms: the pure suitability claim and the disclosure suitability claim.[54] The former relates to some contumelious failure by the seller to deal with integrity and fairness; the latter refers to a failure on the part of the seller to explain a material risk to an unsophisticated buyer. These potential claims stem from the provisions of NYSE[55] and NASD[56] rule-books which

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[42] [1994] 1994] 1 AC 180, [1993] 3 WLR 786.
[43] [1994] 1994] 1 AC 180, [1993] 3 WLR 786.
[44] *Royal Brunei Airlines v. Tan* [1995] 2 AC 378, [1995] 3 WLR 64.
[45] This section is culled largely from an extended discussion of these issues in Hudson, *The Law on Financial Derivatives*, 2nd Edn., (Sweet & Maxwell, 1998).
[46] See, for example, Henderson, "Derivatives Litigation in the United States", Bettelheim, Parry and Rees eds., *Swaps and Off-Exchange Derivatives Trading: Law and Regulation* (FT Law and Tax, 1996), 211.
[47] Civil Action No. C-1-94-620 (S.D. Ohio, filed September 12, 1994).
[48] Civil Action No. C-1-94-735 (S.D. Ohio, filed February 6, 1995).
[49] Ch. 9 Case No. SA 94-22272-JR, Adv. No. SA 94-1045-JR (C.D.BR. Cal., filed January 12, 1995).
[50] Civil Action No. 89-C-3700 (Cir. Ct. Kanawha Co.).
[51] *Chemical Bank v. Washington Power System* 99 Wash. 2d 772 (1983); *Lehman Bros. v. Minmetals* 94 Civ. 8301 (S.D.N.Y.); *Lehman Bros. v. China International* 94 Civ. 8304 (S.D.N.Y.).
[52] Rule 5-31, SFA Rules, considered in *Financial Regulation* below.
[53] See for example, Craig and Hume, "Nightmare 2 - Customers: recent litigation between derivatives dealers and their customers involving issues of fraud, breach of fiduciary duty, suitability, etc. and regulator and industry response", (1995) *Columbia Law Review* 167.
[54] Scott, "Liability of Derivatives Dealers", Oditah ed. (Oxford, Clarendon Press, 1996), 271, 277.
[55] New York Stock Exchange "Know Your Customer Rule", CCH NYSE Guide, sec. 2405.

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create suitability requirements. While it is not clear whether or not the courts would enforce these rules as private law claims, the specific suitability requirements are said to constitute bases on which the courts' understanding of the nature of those claims should be based.

Contrary to the risks associated with mis-selling derivatives, there are the personal risks taken by the officers of the buyer in entering into these products. In one decided US case, directors have been held liable by shareholders for failing to protect the company against market movements by means of hedging derivatives.[57] Alternatively, those directors also run the risk of litigation where their use of derivatives causes loss to the company.[58]

It is therefore contended that the context of credit derivatives contains a number of areas of potential liability where dealers are, in terms, providing insurance to their clients by use of derivatives structures, and necessarily making a series of representations as to the suitability and utility of those products at the same time. The models produced by the seller of a credit derivative product make more representations and require more reliance on the part of the buyer on the expertise of the seller than is the case with vanilla derivative products. The concept of materiality and the calculation and valuation of credit risk create larger areas within which liability in respect of consent, wrongs or unjust enrichment may lie.

It is a fact universally acknowledged that derivatives are risky, if not downright dangerous.[59] Their very use is generally seen by market outsiders as an abuse, of good reason and common sense if nothing else. That is really to overlook the real causes of the derivatives-related crises which have hit global financial markets in recent years: the heart of the big derivatives scandals has been the failure of internal controls. Therefore, in considering the private law implications for derivatives dealers, financial institutions, clients, and shareholders both of clients and of the financial institutions, there are two main forms of risk: first, the rogue trader and, second, the mis-selling cases. In terms of controlling dealer liability in respect of credit derivatives, management of the documentation and dealing function to reduce the risks associated with the mis-selling of complex products or the fraudulent exploitation of non-expert clients by dealers are essential in rebutting claims based on unjust enrichment of the selling institution or wrongs associated with those business practices.

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[56] National Association of Securities Dealers' Suitability Rule, CCH NASD Manual, sec. 2152 (Art. III, sec. 2).

[57] *Brane v. Roth* 590 NE 2d 587 (Ind App 1 dist 1992).

[58] See Henderson, op cit, who explains that shareholders in Proctor and Gamble brought litigation against directors of that company in the wake of litigation with Bankers Trust: *Elaine Drage et al v. Proctor & Gamble et al*, Court of Common Pleas, Hamilton County, April 1994.

[59] See, for example, the borderline hysterical Thompson *Apocalypse Roulette: The Lethal World of Derivatives* (London, 1997).

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