

whether or not they decide to specify the necessity of materiality in the movement of the credit indicator. Typically, the credit indicator will be the market value of the reference asset which, in most cases, will have been issued by the reference entity (as considered above).²⁵⁰ Therefore, materiality will relate to the price of that asset in the market. Alternatively, the credit indicator may refer to a particular spread on the value of that reference asset. A final option is to specify more precisely the credit events required. With reference to any particular asset or entity there will be particular events of default which will specify the materiality of the credit deterioration. In any event, the calculation agent will bear the task of identifying the necessary materiality in whichever indicator is chosen.

1-201 Thirdly, the issue of valuation of the payment to be made under the credit swap. The date and time for valuation of the payment amount is required in the confirmation. The ISDA standard form is for quotations to be taken from market-makers. There is a need to choose between the use of bid, offer and mid-market levels from those market-makers. Having identified the levels, the precise method of calculating the market level is then necessary: whether that be an average of market levels, the highest point in the market, or the market level at a particular time.

1-202 Performance of the payment then occurs by delivery of the physical portfolio of assets required, or cash settlement.²⁵¹ The confirmation will be required to provide for a settlement mechanism in the event that the transaction cannot be performed. Where there has been a credit event, it might be that delivery of assets becomes impossible due to some market failure, or that delivery becomes illegal or impossible under the terms of the underlying reference asset. Delivery is then usually provided in the agreement to be made to the extent possible, or within a reasonable time after the contractual delivery period. Provision for the availability of default penalties for failure to deliver on time, are also necessary. In the event that physical delivery is required, it may be prudent to provide for an alternative of cash settlement in the event that delivery continues to be impossible for a given period after delivery ought to have been made.

1-203 Given the importance of the underlying reference asset to the structure of the derivative, it is important to avoid mismatches in business and currency days, and so forth, and to provide for a mechanism in the derivative documentation to cope with failures in the underlying reference asset. For example, where the reference asset is redeemed otherwise than in accordance with its ordinary redemption, or where the credit support or other covenants surrounding the underlying reference asset fail, a mechanism for terminating and settling the derivatives transaction will be necessary.

²⁵⁰ In identifying the material movement in the market value of the asset, the confirmation must set out the time at which that market level is to be identified, in relation to which exchange or index that level is being calculated, and whether that level is to continue for any length of time.

²⁵¹ The portfolio refers to the reference assets and other assets which are required under the terms of the transaction to be provided in settlement of the transaction.

Issues with documentation and complexity

The complexity involved in many of these transactions is an enemy of legal certainty, and sometimes even basic competence. As Lord Collins noted in *UBS AG v HSH Nordbank AG*:²⁵²

“The contractual documentation in this matter consists of more than 500 pages and its size and complexity, which is no doubt duplicated in many other transactions, make it easier to understand, if not to excuse, why senior banking figures (but not necessarily in this case) had little understanding of this market and of the risks their institutions were undertaking.”

One of the most common mistakes in these sorts of transactions is that mismatches between documents creep in so that when the courts come to interpret the mess left by the parties, it is very difficult indeed to identify their intentions, the appropriate system of law and jurisdiction, and so forth. So, in *UBS v HSH Nordbank*, for example, some of the many different documents for each element of a CDO were subject to New York law and others subject to English law. Similarly there were different jurisdiction clauses. Consequently, a claim for misrepresentation was held up behind interlocutory questions as to jurisdiction given these contradictions.

FOREIGN EXCHANGE DERIVATIVES

Currency options

Currency options are options to purchase a given quantity of a currency at a price at a date in the future. In a currency option, the buyer acquires a right, but not an obligation, to put or to call for a given amount of a currency which can be acquired for an identified quantity of another currency. In foreign exchange markets it is more common to settle these transactions “physically” by a transfer of the amounts of currency as opposed to the “cash settled” procedure used in most other financial markets whereby the buyer only wishes to receive the cash return which it would have earned had it participated in the spot market for that currency. Currency options are thus options to purchase a given quantity of a currency at an identifiable price at a date in the future. The currency option does not include an interest rate movement in its price; although what a currency option does do is to enable the holder of the option to benefit from a movement in the interest rate attached the relevant currency against the interest rate that is payable on the currency. The currency option operates as a means of hedging against movements in the underlying currency or as part of a portfolio strategy which enables the investor to acquire the right to acquire currency at a price lower than the spot price if the option is in-the-money.

²⁵² *UBS AG v HSH Nordbank AG* [2009] EWCA Civ 585; [2010] 1 All E.R. (Comm) 727 at [2].

Currency swaps

- 1-206 A currency swap usually takes place in three stages.²⁵³ First, there is an initial exchange of amounts in different currencies, usually set at a particular exchange rate (normally the spot exchange price on the contract date). Secondly, periodic payments are made by each party to the other calculated by reference to the amounts which each party received under the initial exchange. The precise amounts of the payments are fixed by applying the rate of interest applicable to that particular currency. This is the "swap" element: each party is paying the interest rate appropriate to their currency under the transaction, and so the risk that each party takes is that the interest rate on their currency exceeds the interest rate on the other currency thus requiring that party to pay an excess. Finally there is a re-exchange of currency amounts which reverse the initial exchange. The effective transfer between the parties, then, is a payment of the differential between the interest rates payable on each currency.²⁵⁴

Cross-currency interest rate swaps

- 1-207 Cross-currency interest rate swaps are hybrids in which one party makes payments in one currency at a fixed rate of interest while its counterparty makes payments in another currency at a floating rate of interest. The genesis of this form of dealing was in bond issues where the purpose of the issue was to enable the issuer to enter into a swap and thus reduce the effective cost of funding. Therefore, it became possible to entice investors to participate in a bond issue where, in the normal run of events, the investment vehicle would not have been able to raise a particular type of funding because of its credit standing.
- 1-208 The market standard documentation was framed to deal with swaps transactions before it was adapted to deal with the more exotic derivative products.²⁵⁵ Therefore, cross-currency interest rate swaps transactions are documented first by a deal ticket and then by the execution of a confirmation.²⁵⁶ The confirmation sets out the terms of the transaction, including commencement, payment and maturity dates. It will also specify the relevant currencies, accounts for payments to be made and will, at the discretion of the parties, deal with a number of terms such as termination. However, these more complex terms are generally left to be set down in a master agreement.²⁵⁷ The commercial risk management functions of the parties will have to cater for the situation in which transactions are conducted in the absence of a fully executed master agreement. There is increased risk in the transactions where there is no master agreement to

²⁵³ "Cross-currency interest rate swaps" are hybrids in which one party makes payments in one currency at a fixed rate of interest while its counterparty makes payments in another currency at a floating rate of interest. The genesis of this form of dealing was in bond issues where the purpose of the issue was to enable the issuer to enter into a swap and thus reduce the effective cost of funding.

²⁵⁴ Some currency swaps may omit the initial and/or the final exchange of currency. A currency swap strictly refers to the situation where the rate of interest payable by each party as part of the periodic payments is fixed for both parties. In particular circumstances there may be a "timing mismatch" where payments are made at different times or in relation to different periods by different parties. Therefore some will gain at the expense of others.

²⁵⁵ The documentation issues are discussed in more detail in Ch.2.

²⁵⁶ Discussed below at para.2-26.

²⁵⁷ The relationship between these documents is discussed fully in para.2-08 et seq.

regulate the dealings between the parties.²⁵⁸ In circumstances where physical amounts of currency are exchanged, the documentary regime is sometimes different for a foreign exchange transaction from that for an interest rate swap. The structure of the product is dependent upon the specific priorities of the bank and the issuer. It will however, follow the pattern set out in the sections dealing with interest rate swaps²⁵⁹ and currency swaps,²⁶⁰ depending on whether the intention is to produce a commercially efficient rate of funding or to provide the client with a specific amount of the foreign currency.

Documentation

Currency interest rate options are structured in a way that is similar to the swaps considered above (and their documentation in detail in Chs 2 and 3). While the ISDA form of standard documentation will be suitable for these forms of product, the foreign exchange market typically used the IFEMA²⁶¹ form of documentation, but now it has been displaced by the International Foreign Exchange and Currency Option Master Agreement ("IFXCO") which was published on June 1, 2005 by the Foreign Exchange Committee in association with the British Bankers Association and others.²⁶² This document is discussed in Ch.2.

The options provisions of IFXCO are supplied by the International Swaps and Derivatives Association ("ISDA") "FX and Currency Option Definitions" of 1992. Thus the provisions of IFXCO and the ISDA Master Agreement and Confirmations considered in Chs 2 and 3 are brought together by dint of common definition of terms. Indeed, many institutions doing derivatives business in the foreign exchange markets do use the ISDA Master Agreement to document those transactions. In using the ISDA documentation,²⁶³ the contractual form of the products is based upon the same master agreement as the interest rate swap, discussed below; however, the detail of the confirmation is necessarily different. Instead of a series of payment dates by which payments are calculated as amounts of interest as in an interest rate swap, the currency option entitles the investor to receive or sell an amount of currency. Alternatively, it may be provided that an entitlement to receive an amount in one currency is to be exchanged for the equivalent amount in another currency. Therefore, the documentation is structured to take account of the delivery and calculation method. There is a strike price for the option which governs whether or not it can be exercised, whereas an interest rate swap is necessarily effective from the time when it is sold. The market conventions are necessarily those appropriate to foreign exchange products. There is a need to ensure that there are no mismatches between the appropriate business day conventions in relation to each currency.

²⁵⁸ The credit risk and collateral implications are discussed in para.12-05 et seq.

²⁵⁹ See para.1-96.

²⁶⁰ See para.1-205.

²⁶¹ IFEMA being the acronym for "International Foreign Exchange Master Agreement".

²⁶² The IFXCO agreement is available at www.newyorkfed.org/fxc. [Accessed February 1, 2012.]

²⁶³ With reference to the definitions published by ISDA: ISDA, *FX and Currency Option Definitions* (ISDA, 1992).

outstanding at that time.¹⁸ In the joined cases of *Anthracite Rated Investments (Jersey) Ltd v Lehman Brothers Finance S.A. in liquidation* and *Fondazione Enasarco v Lehman Brothers Finance S.A. & Anthracite Rated Investments (Cayman) Ltd*¹⁹ the parties created linked bonds and derivatives which in effect hedged them. In their master agreement it was provided that there would be mandatory termination of the master agreement in the event, for example, that there was a breach of the terms of the bond issue. Thus, rather than rely on the non-defaulting party giving notice to commence the termination procedure, the parties agreed that there would be, in effect, an automatic termination of their master agreement. Otherwise, there would be the possibility of mismatches between the documentation style of one instrument and the documentation style of the other. The ISDA Master Agreement therefore needs to be pruned back so that concepts which are peculiar to it can mesh with the documentation for another type of instrument.

3-10

The weakness with automatic termination is that it gives the non-defaulting party no opportunity to decide whether or not it would wish the transaction to be terminated or affirmed. It may be, even though an event of default of some sort had occurred, that the defaulting party is continuing to make payment under the transaction and that the transaction is profitable for the non-defaulting party. In such a circumstance, the non-defaulting party would not want the defaulting party to be able to rely on an automatic early termination provision and so end its obligation to keep making payment to the non-defaulting party. Therefore, a preferable provision from this perspective might give the non-defaulting party the option to choose whether to terminate or to affirm the transactions. However, this would raise issues in cases of insolvency relating to the unacceptability of allowing a solvent party to cherry-pick which transactions it would prefer to affirm and which it would prefer to repudiate. It is suggested that such a provision would not be acceptable in relation to insolvency set-off and as such ought to be excluded on the basis that it would offend against the *pari passu* principle²⁰ and the anti-deprivation principle in insolvency law,²¹ as discussed in Ch.13 in detail.²²

The interpretation of the termination provisions in the ISDA Master Agreement

3-11

The principles governing the interpretation of contracts are considered in detail in Ch.8.²³ What is clear is that the English courts will take an approach which begins with the wording of the contract itself and then considers any material

¹⁸ If there was a collateral structure in place, then the non-defaulting party would be able to have recourse to that structure and would have a vested right in any property provided by way of a "proprietary collateral structure" or no obligation to make any repayment under a "personal collateral structure", as those terms are considered in Ch.12 of this book on Collateralisation. See para.12-15 for an analysis of this distinction.

¹⁹ *Fondazione Enasarco v Lehman Brothers Finance S.A. & Anthracite Rated Investments (Cayman) Ltd* [2011] EWHC 1822 (Ch); [2011] All ER (D) 171 (Jul).

²⁰ See *Re BCCI (No.8)* [1998] A.C. 214; *Secretary of State for Trade and Industry v Frid* [2004] UKHL 24; [2004] 2 A.C. 506.

²¹ *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38; [2011] 3 W.L.R. 521 and *Lomas v JFB Firth Rixson Inc* [2011] 2 B.C.L.C. 120.

²² See para.13-86.

²³ See para.8-25.

which throws light on the context in which that agreement was created, as set out by Lord Hoffmann in the House of Lords in *Investors Compensation Scheme v West Bromwich Building Society*.²⁴ In *Lomas v JFB Firth Rixson Inc*²⁵ Briggs J. (as considered in the previous chapter)²⁶ took an approach to the interpretation of the ISDA Master Agreement which was determined to introduce commercial common sense to it and which refused to read the condition precedent provision in s.2(a)(iii) as requiring that a breach of that condition precedent was a once-and-for-all breach of the master agreement. It is suggested that this overlooks the basis on which ISDA created that agreement in the first place: their purpose was to enable the large swaps dealers to terminate and exit their transactions as easily as possible at the first sign of trouble, and not to bind them into those agreements. However, the reasons why two contracting parties might decide to use that agreement and to modify or not to modify any given provision in the standard terms may be very different from the intentions of the committees which first put those agreements together.

3-12

It is helpful when considering the ISDA Master Agreement, which was of course a document created by ISDA which was an organisation created by those investment banks (at a time when the acronym "ISDA" actually stood for the "International Swaps Dealers Association"), to think of those banks and other swaps dealers as being nervous rabbits. A nervous young rabbit is a rabbit which is likely to survive longer in the wild than brave young rabbits or young rabbits that do not experience fear.²⁷ A rabbit is far more likely to survive in the wild if it learns to be aware of potential threats. A nervous rabbit, with its constantly twitching nose, will always be smelling the breeze and listening out for predators and other dangers. A nervous rabbit is always ready to run to safety. So it is with investment banks using master agreements. An investment bank will always be sniffing the air looking to see if its counterparties might be unable to repay their obligations to that bank. The master agreement contains a range of mechanisms for allowing the parties to extricate themselves from their transactions. By allowing a master agreement to be terminated because there has been a default under a transaction with an entirely unrelated party means that the investment bank can terminate its outstanding transactions with its counterparty simply because it can smell a danger on the breeze. For example, if the counterparty has failed to make a payment of interest on its ordinary borrowings, then that would indicate to its derivatives counterparties that that counterparty-borrower is in danger at some point in the future of defaulting on its derivatives obligations. Rather than have to wait for the counterparty actually to default, the investment bank would prefer to be entitled to terminate its master agreement before that event arises. Just as the nervous rabbit will scamper away to its burrow at the first hint of danger, the investment bank is able to call in all of the amounts which are owed to it under the master agreement before the counterparty falls.

²⁴ *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 W.L.R. 896; [1998] 1 All E.R. 98 at 115.

²⁵ *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch); [2011] 2 B.C.L.C. 120.

²⁶ See para.2-122 et seq.

²⁷ Certainly if you go out into the English countryside in early spring then you will find that young rabbits will happily come and nibble at the grass round your feet as you sit because they have not yet learned to be nervous of anything that is not a rabbit. The same is true, in my experience, of blackbirds. But I digress.

3-13

If one bears this model of investment banks in mind when interpreting the ISDA Master Agreement, it is possible to understand all of the termination provisions, which appear to be susceptible of a very broad interpretation which would potentially terminate all outstanding transactions on the slightest of infractions *when read literally*, as being intended to terminate all outstanding transactions very quickly indeed. In consequence, legal advisors to corporate clients were always suspicious of this agreement because it was created by a trade association which represented swaps dealers and which was designed to protect their interests. Alternatively, one can adopt the sort of commercial common sense readings adopted by Briggs J.²⁸ and Flaux J.²⁹ which look for the commercial common sense which must be imputed to the parties' contract when considering whether or not it should be terminated. It is suggested that the purpose of the ISDA committees which debated and drafted these documents was to provide easily accessible escape routes for the parties. However, that is not dispositive of the question whether or not parties to any individual master agreement should be taken to have intended the same thing as the ISDA committees.

3-14

Indeed a further issue arises. When interpreting an ISDA Master Agreement, the ordinary approach of the English courts is to assume that the interpretation of contracts is concerned with the voluntary will of the parties and their legal advisors as expressed in contractual form. However, in derivatives transactions what the courts are considering are standard form documents which are not tailor-made for the individual parties (instead they are supposed to rely upon the schedule to their master agreement to achieve an approximation of that) and therefore the intentions of the parties and the context in which they are contracting might be different from the intentions of those who drafted the contracts in their standard form. In *Abu Dhabi Commercial Bank v Saad Trading*³⁰ the court seemed to take the view that ISDA's intention when drafting the master agreement was significant in its interpretation, and not simply the intention of the parties as expressed in their agreement.³¹ Briggs J. was very much aware of the important role of the ISDA Master Agreement in financial markets in his judgment.³² As his lordship explained in *Lomas v JFB Firth Rixson Inc.*,³³ in advertently shining a light on the manner in which many parties create and experience their ISDA Master Agreements:

"... the Master Agreement was a clearly and precisely drafted document, developed over many years, into which the implication of terms was unnecessary and undesirable, both because of the clarity of its meaning, and because of the various options provided by ISDA whereby parties could, by additional provisions in the Schedule or in any Confirmation, make specific provision about particular matters. Unfortunately, the respondents attempt to make that starting point good led them

²⁸ *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch); [2011] 2 B.C.L.C. 120.

²⁹ *Marine Trade SA v Pioneer Freight Futures Co Ltd BVI* [2009] EWHC 2656 (Comm); [2009] All E.R. (D) 30 (Nov).

³⁰ *Abu Dhabi Commercial Bank v Saad Trading* [2010] All E.R. (D) 294 (Jul).

³¹ It is a difficult issue, as explained in Ch.8, to interpret contracts objectively on the basis of their terms and the objective factors which throw light on the context in which they were created, but not simply by reference to the subjective intention of the parties: *BCCI v Ali* [2001] 1 A.C. 251 at 259, per Lord Bingham.

³² *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch); [2011] 2 B.C.L.C. 120.

³³ *Lomas v JFB Firth Rixson Inc* [2010] EWHC 3372 (Ch); [2011] 2 B.C.L.C. 120 at [59].

into protracted disagreements between themselves as to the meaning and effect of the condition precedent in Section 2(a)(iii)...."

The tension between the purported clarity of the ISDA Master Agreement when confronted by the difficulties of the parties in attempting to use and to interpret it is clear. This preamble to the consideration of the termination procedures is intended to illustrate that the clarity of the ISDA documentation is only apparent if one interprets it to mean, in general terms, that the parties should be permitted to terminate their agreement for what may seem like a slight infraction if that is what a literal reading of the contract would suggest should happen. When one attempts to identify the intentions of the parties or what appears to be commercially sensible outside the standard terms of that agreement then matters become much more difficult. In several provisions in the discussion to follow it is provided in the standard terms that an event leading to termination will arise if there is a breach of "any agreement or obligation" by the parties, something which appears to be overly broad but which appears too often in the agreement (in relation to "breach of agreement" and "failure of credit support", for example) to be accidental. It is suggested that this "draconian effect", as Briggs J. was moved to call it, was entirely intentional on the part of those who drafted the agreement originally. What is not clear is whether or not the parties to any given master agreement actually intended the provision to be so broad if they are only using this standard language as a compromise between themselves on the form of contract to use, or because they believe that best practice requires them to use this form of contract even if they do not agree with every nuance in the drafting.

EVENTS OF DEFAULT

Introduction

The "Events of Default" in the ISDA Master Agreement are eight in number in the standard form, although the parties may add events of default through the schedule to their master agreement. They are set out in s.5(a) of the ISDA Master Agreement. The events of default require that the non-defaulting party (that is, the party who has not committed the event of default) must serve a notice on the defaulting party both identifying the event of default at issue and also that the termination procedure is then begun. The non-defaulting party must nominate an "Early Termination Date" and then the termination procedure considered at para.3-94 et seq. begins. The termination procedure is analysed below³⁴; for the present we shall focus on the extent and terms of the events of default and identify what will and what will not fall within them. Each of the events of default is taken in turn. The discussion considers the various types of event of default in general terms and refers where necessary to the applicable ISDA Master Agreement language from the 1992 or the 2002 editions of that agreement, as appropriate, as they have appeared in the decided cases.

3-15

³⁴ See para.3-96.

terminate only a few (and if so, who is entitled to exercise that election). In conducting its calculation, the calculation agent may take into account quotations (although a minimum number required is not specified), it may also rely on "market data", and more concerning perhaps it may rely on "internal sources" if that information is used by the calculation agent in the ordinary course of its business. In essence, the calculation agent may act as they please provided that they follow these few indicators. The calculation agent is required to "consider" any quotations, but is not bound by them.

- 3-129 It is the common law notion that a calculation agent must act in good faith and that it may be a fiduciary, as considered in detail above²³⁵ that constrains the manner in which the calculation is performed equally well. It is suggested, given the large amount of largesse which is given to the calculation agent in this context, that the Determining Party must be accorded fiduciary status in this context so that no conflicts of interest may be permitted, so that all calculations must be justifiable, and so that any undue personal advantage taken from this process which is not permitted by the contract (where that stands for the terms of that person's fiduciary office) must be held on constructive trust for the other party.²³⁶

Issues with selective termination

- 3-130 The first issue in relation to the termination procedure is whether or not the parties want automatic termination to apply.²³⁷ The risk is that a counterparty may realise that its swap position, possibly with numerous counterparties if it is speculating, is out-of-the-money and that it needs to terminate the swap position without incurring the cost of unwinding its positions. Therefore, it may choose to cause a mandatory event of default to be activated so that the swap is compulsorily terminated and payments netted off. By barring this event, the parties achieve a result that is closer to a rolling credit-watch than a speculator's tool. Furthermore, by precluding automatic termination but retaining the right to terminate, the party to a master agreement can balance the decision whether to terminate an unprofitable deal but be safe from the future credit risk, or keep a profitable position alive while taking a strong view on the future credit risk of a defaulting counterparty.
- 3-131 What is not clear is whether or not the doctrine of estoppel would apply with reference to a party who chooses not to exercise a right of termination but who later attempts to terminate that swap at a time when the counterparty is, for example, forced into insolvency by the cost of termination.²³⁸ The situation might be different where a party commits a Credit Event upon Merger, for example, and its counterparty chooses not to exercise termination rights. If that Event continues, the defaulting party is probably entitled to believe that the counterparty will not exercise rights of termination in respect of that event in the future and could continue in reliance on that fact.²³⁹

²³⁵ See para.2-21.

²³⁶ In accordance with the principle in *Boardman v Phipps* [1967] 2 A.C. 46.

²³⁷ Considered at para.3-07.

²³⁸ For example, *Jordan v Money* (1854) V HLC; (1854) 185 10 E.R. 868; *Oliver v Bank of England* [1902] 1 Ch. 610. cf. *Co-operative Bank v Tipper* [1996] 4 All E.R. 366.

²³⁹ For example, *Jordan v Money* (1854) V HLC; (1854) 185 10 E.R. 868; *Oliver v Bank of England* [1902] 1 Ch. 610. cf. *Co-operative Bank v Tipper* [1996] 4 All E.R. 366.

Termination currency

The termination currency provision identifies the currency in which the termination payments are to be made. There may be advantages in paying or receiving in a currency different from the contractual currency of each transaction. Alternatively, different transactions may be entered into on the basis of different currencies.

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Entire agreement and exclusion of liability

The master agreement provides that the master agreement will constitute the entirety of the agreement between the parties and that no other document or material or oral discussion between the parties' agents will constitute a part of the contract.²⁴⁰ However, such an entire agreement provision did not prevent a collateral agreement to the master agreement being found in *AS Klaveness Chartering v Pioneer Freight Futures Co Ltd*.²⁴¹ Furthermore, the English law approach to interpretation²⁴² requires that the context in which the contract was created is part of the objective approach to interpreting that contract.²⁴³

3-133

Another aspect to this provision might be that because the parties intend the document to constitute their entire agreement to the exclusion of any verbal or other representations or agreements made between the parties that consequently this provision may seek to exclude any liability for misrepresentation.²⁴⁴ Under English law, however, such a provision will not exclude the liability of a party who makes an actionable misrepresentation to its counterparty.²⁴⁵ It would not be expected that doctrines of fraud, misrepresentation or constructive fraud would be excluded by an English court in circumstances in which, for example, a complex derivative product was being sold to a less experienced customer.²⁴⁶ The reason for that would be the expectation that the terms of that transaction were dictated by the party seeking to exclude its liability. It is suggested that liabilities for misrepresentation, fraud and constructive fraud would be considered in general terms to be mandatory rules which ought not to be excluded in circumstances in which a contractual term, which formed part of a contract which was created in reliance on such misrepresentation or fraud, sought to exclude liability for that fraud or misrepresentation.

3-134

A court may be convinced that such a provision could be taken at face value in relation to a contract between similarly experienced professionals. However, even in such a situation it is suggested that such a provision ought not to be enforced if

3-135

²⁴⁰ This provision appeared, for example, in *Lehman Brothers Commodity Services Inc v Credit Agricole Corporate and Investment Bank (formerly Calyon)* [2011] EWHC 1390 (Comm); [2011] All E.R. (D) 26 (Jun).

²⁴¹ *AS Klaveness Chartering v Pioneer Freight Futures Co Ltd* [2009] EWHC 3386 (Comm); [2009] All E.R. (D) 191 (Dec).

²⁴² See para.8-25.

²⁴³ See, for example, *Lomas v FJB Firth Rixson Inc* [2010] EWHC 3372 (Ch); [2011] 2 B.C.L.C. 120.

²⁴⁴ ISDA Master Agreement 2002 s.9(a).

²⁴⁵ *Thomas Witter v TBP Industries* [1996] 2 All E.R. 573; cf. *EA Grimstead & Son Ltd v McGarrigan* [1998-99] Info. T.L.R. 384; 1999 WL 852482. *Watford Electronics Ltd v Sanderson* [2001] EWCA Civ 317; [2001] 1 All E.R. (Comm) 696; in relation to estoppel of pre-contractual representations.

²⁴⁶ cf. *Bankers Trust v Dharmala* [1996] C.L.C. 461; para.7-15 et seq.

the misrepresentation or the fraud related to some factor—for example, information as to the representor's financial situation—which induced the counterparty to enter into that transaction. It would only be in relation to some issue which the counterparty could be taken to have equivalent knowledge of—for example, the effect of interest rate movements on an interest rate swap—that such an exclusion clause could be effective. Reference in this regard should also be made to the discussion of unfair contract terms²⁴⁷ and the liability of sellers of derivatives.²⁴⁸

Set-off under the master agreement

- 3-136 The general law on set-off is considered in detail in Ch.13. This section considers the ISDA Master Agreement which purports to grant a very broad set-off indeed over-and-above the general law on set-off. In this regard in *Lehman Brothers Commodity Services Inc v Credit Agricole Corporate and Investment Bank (formerly Calyon)*²⁴⁹ s.6(f) of the Calyon Master Agreement²⁵⁰ provided that:

“(i) In addition to any rights of set-off a party may have as a matter of law or otherwise, upon the occurrence of an Event of Default, Credit Event Upon Merger, or an Additional Termination Event and the designation of an Early Termination Date pursuant to Section 6 of the Agreement with respect to a party (“X”), the other party (“Y”) will have the right (but not be obliged) without prior notice to X or any other person to set-off or apply any obligation of X owed to Y (whether or not matured or contingent and whether or not arising under this Agreement, and regardless of the currency, place of payment or booking office of the obligation) against any obligation of Y owed to X (whether or not matured or contingent and whether or not arising under this Agreement, and regardless of the currency, place of payment or booking office of the obligation).”²⁵¹

In essence then, when an event of default occurs and the termination procedure is begun, the non-defaulting party may set off all outstanding obligations under any outstanding transactions: this format requires that notice be given before the set-off is conducted. It is suggested that in the event of the nomination of an early termination date as part of the termination procedure that the parties should be provided to have an automatic set-off, to the extent permitted by any relevant system of law. Under English insolvency law, as considered in Ch.13, the set-off would be mandatory under r.4.90 of the Insolvency Rules 1986 if there are mutual debts owed between the parties.²⁵²

- 3-137 Significantly this provision purports to grant a right to set off amounts owed under other agreements as well as under the master agreement. It is suggested that in relation to set-off on insolvency this would only be sufficient to establish mutual debts, as considered in Ch.13, if this was considered sufficient to establish “mutual dealings” between the parties with r.4.90 of the Insolvency Rules

²⁴⁷ See para.6-102.

²⁴⁸ See para.7-01 et seq.

²⁴⁹ *Lehman Brothers Commodity Services Inc v Credit Agricole Corporate and Investment Bank (formerly Calyon)* [2011] EWHC 1390 (Comm); [2011] All E.R. (D) 26 (Jun).

²⁵⁰ Inserted by Pt 5(c) of the Schedule

²⁵¹ The provision is not intended to create a charge or other security interest.

²⁵² See para.13-61.

1986.²⁵³ In *Lehman Brothers Commodity Services Inc v Credit Agricole Corporate and Investment Bank (formerly Calyon)*²⁵⁴ a letter of credit was issued in relation to a derivatives transaction documented under an ISDA Master Agreement; the parties were already parties to another ISDA Master Agreement which was used for other transactions (“the Calyon agreement”). When Lehman Brothers Holdings, Inc went into insolvency in September 2008, this triggered an event of default under the ISDA Master Agreements on the basis of a failure of the credit support provider under those agreements. The issue which arose for decision was whether or not there should be a set-off between the early termination amount under the Calyon agreement and the amounts owing under the letter of credit. It was held that there was no provision to the contrary and no reason for there not to be equitable set-off in general terms across the two agreements. Section 6(f) of the ISDA Master Agreement purported to permit set-off in general terms of amounts owing between the parties. Having heard expert evidence as to New York law in this context in so far as it covered the Calyon agreement, Field J. held that there was no reason to exclude the use of set-off between the Calyon agreement and the letter of credit. No point was taken as to the effect of this analysis under the English insolvency law anti-deprivation or *pari passu* principles; rather the analysis focused solely on the position under New York law. However, the approach taken by Lord Collins in *Belmont Park Investments v BNY Corporate Trustee Ltd*²⁵⁵ suggests a more relaxed attitude to matters of set-off on insolvency in general terms; although whether it should extend to situations in which the set-off is intended to be enforced across different transactions which are unconnected by an express, common contractual provision would seem to stretch to breaking point the principle that some unsecured creditors should not be given an advantage over other unsecured creditors by taking assets from the estate of the insolvent person.²⁵⁶

²⁵³ See para.13-61.

²⁵⁴ *Lehman Brothers Commodity Services Inc v Credit Agricole Corporate and Investment Bank (formerly Calyon)* [2011] EWHC 1390 (Comm); [2011] All E.R. (D) 26 (Jun).

²⁵⁵ *Belmont Park Investments v BNY Corporate Trustee Ltd* [2011] UKSC 38; [2011] 3 W.L.R. 519 at [107]–[110].

²⁵⁶ Questions as to solvent set-off arose in *Lisa Bo Larsen and Michael Ziegler (Foreign Representatives of Atlas Bulk Shipping A/S) Atlas Bulk Shipping A/S (in Bankruptcy) v Navios International Inc* [2011] EWHC (Ch) 878, in which Atlas Bulk Shipping was not the subject of insolvency proceedings but which was the subject of such proceedings elsewhere, with the consequence that this was a case primarily concerned with cross-border insolvency. It was held *inter alia* that the general law of set-off considered in Ch.13 applied as to whether or not set-off would be appropriate between solvent parties, albeit that on the facts the more pressing issue was the appropriateness of foreign insolvency proceedings under private international law.

properly to terminate that contract automatically.¹²⁰ Similarly, even if a term is a mere warranty, then it would be important in the derivatives context to identify the size of the loss which might be expected to flow from its breach. This is particularly important in circumstances in which the loss which might result is the cost of closing out a hedge which the courts might not otherwise consider to fall within the master agreement's definition of "loss".¹²¹ Recent case law on this topic was considered in detail in Ch.3.¹²² The question of breach of contract is considered in detail in Ch.8 *Performance and interpretation of derivatives contracts* and the more general issues of the restitution of property paid under derivatives contracts is considered in Ch.9 *Termination of derivatives contracts*.

CASE STUDIES: CONFUSION IN THE TRANSACTION PROCESS

The case of Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd

The decision at first instance

5-65

One of the more difficult problems facing an in-house counsel in a large financial institution serving a derivatives trading floor arises when there is confusion about the creation of a transaction. The beginning of this chapter considered the sorts of problems which arise between traders, or between a trader and a client, when there are errors, misunderstandings, misrepresentations and so on. This section considers a decided case in the English High Court¹²³ which deals with exactly these sorts of problems involving the creation of complex derivatives contracts which typically involve a number of different actors, including traders, account managers liaising with corporate clients, financial intermediaries and non-market counterparty clients; the next section considers the appeal in this case to the Court of Appeal. There were two very different understandings of the same factual circumstances in those courts. When considering the creation of high-volume derivatives contracts it is important to understand that those contracts are generally created by means of fast-moving negotiations between traders in which, while the majority of transactions will be created and performed without a hitch, there will often be mistakes, misunderstandings and misrepresentations made between those traders. In relation to low-volume, structured derivatives the negotiations between the parties will take some time and the product at issue may change its nature considerably during those negotiations: this is because the product is generally constructed by traders and marketed by account managers, such that there may be mismatches between the understandings of those traders, of those account managers and of the customers who rely on them.

¹²⁰ See para.3-07.

¹²¹ See para.3-111.

¹²² See para.3-111.

¹²³ *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2005] EWHC 830 (Comm); reversed on appeal.

5-66

An illustration of these issues arose in *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd*.¹²⁴ In 1998 a short-lived market arose in Russian government bonds. Latterly a banking moratorium was declared in Russia, but at this time those bonds were trading at a discount to their face value which meant that the bonds appeared to be cheap compared to that face value although they carried high risks. The Australia and New Zealand Banking Group Ltd ("ANZ") marketed products to a range of its customers which related to Russian bonds known as "GKO's". The particular client which commenced this litigation was Peekay Intermark Ltd ("Peekay"), acting through its director and controlling shareholder Mr Pawani. The facts of the case are long and involved, and reading the judgment in full undoubtedly repays the effort: not least as an illustration of the things which can go wrong in the creation of a complex derivative product thus raising questions about whether or not a binding contract has been created.

5-67

Briefly put, the facts were as follows. Pawani had considerable investment experience, including dealing in derivatives, and was described as a "sophisticated individual and an experienced trader" by the trial judge. We are told nothing of ANZ's approach under the applicable conduct of business regulation to their decision to sell complex products to Peekay via Mr Pawani. This entity had been trading in emerging market investments of various kinds since 1996. The original form of the product was described in ANZ's literature as being a "Note giving GKO Returns Hedged back In USD" [sic], and was in turn a form of product inspired originally by products sold by CSFB. However, ANZ's traders later developed a different form of product which was a "deposit" rather than a "note". The "Indicative Term Sheet" sent to Pawani indicated that the product was a hedged note in relation to which Peekay would acquire a beneficial interest in the GKO held for it by ANZ, whereas in fact Peekay would acquire no such right under the product which was ultimately put in place with the result that Peekay was exposed to Russian rouble risk if a banking moratorium was declared, as opposed to being hedged in US dollars.

5-68

What is clear is that the account manager, Mrs Balasubramaniam, who consulted with Pawani had not appreciated that the traders who were constructing the product had changed the nature of the product. It was clear that Pawani had not read any of the documentation which ANZ sent to him in any detail because he was relying on the verbal representations made to him by the bankers. It was found by the trial judge that Pawani had glanced at the documentation he had been sent but that he had not read it fully because he assumed, on the basis of previous transactions, that it represented their verbal discussions. He considered the completion of the documentation to be a "mere formality" after the real business of the verbal discussions had been completed. At the time of agreeing verbally with the account manager that Peekay would acquire this investment, Pawani contended that he had seen no other documentation. ANZ issued further documentation explaining in passing that the product was a deposit. It was not clear at what stage this realisation bore in on Pawani. The account manager did not see Pawani's acceptance letter, which showed that he considered the company was acquiring a "note" rather than a "deposit". However, the judge at first instance made it clear that Pawani's evidence lacked credibility in a number of

¹²⁴ *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2005] EWHC 830 (Comm).

particulars. Nevertheless what was found on the facts as to the documentation trail was the following, in the words of the judge, Siberry QC:

"[The account manager] said that when she first saw this Contract Note (apparently in the course of proceedings), she was 'mystified, shocked and perplexed all in one. She described it as 'a very sloppy operational effort, and 'completely bizarre, adding, 'It's got wrong written all over it, and that it 'should never have gone out to the customer ... There was no such thing as a USD GKO."¹²⁵

The passage just quoted from the decision in *Peekay v Intermark Ltd v Australia and New Zealand Banking Group Ltd* demonstrates that within financial institutions the documentation process may happen at speed as the products are being developed and as on-going discussions are being conducted between a number of different people both acting on behalf of financial institutions and acting as financial intermediaries advising customers. Even when the product takes some time to put in place, there are still many opportunities for the many actors involved to create confusions, to make misrepresentations, and to make material changes to the product without communicating those changes suitably to the other people involved.

In this case, Peekay contended that it had been induced to enter into this contract on the basis of negligent misrepresentations made to it as to the nature of the product. On these facts, it was held that the nature of the product had indeed been misrepresented to Pawani, while acting on behalf of the claimant company, Peekay. Even though it was not clear exactly to what extent Pawani had been misled, and even though Pawani was acknowledged to have had experience in derivatives trading, it was clear that the nature of the product as sold was materially different from the product as originally described to Pawani. Consequently, it was held that Peekay had been induced to enter into the contract by the misrepresentation and consequently that Peekay was entitled to damages further to s.2(1) of the Misrepresentation Act 1967 equal to the difference between the actual return on the product and the original investment.¹²⁶ However, this decision was reversed on appeal by the Court of Appeal, as considered in the next section.

Two things happened in the course of the transaction which are significant in relation to the discussion of the standard market documentation in Chs 2 and 3 of this book. First, there was no single confirmation put in place which documented the parties' intentions. Secondly, there were at least two groups of marketing material which conflicted as to the nature of the investment at issue, and latterly a "Risk Disclosure Statement" after the contract had been created orally. As the judge held, "[w]hat was on any view most unsatisfactory was that there was no documentation correctly recording the terms of Peekay's investment". In derivatives markets, it is commonly the case that a large number of transactions are created—usually with only a short period from "start date" to "exercise date"—but sometimes, as with *Peekay v ANZ*, there are more complex products which are undocumented or are subject to documentation which omits a number

¹²⁵ *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2005] EWHC 830 (Comm) at [46].

¹²⁶ *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2005] EWHC 830 (Comm) at [97].

of significant legal provisions which the traders do not know they should settle between them. This is a key area of risk in the creation of derivatives.

Therefore, while the answers to many of the undergraduate level questions raised in this chapter—for example, how is a contract created? Can a contract be created orally? What if the parties act under a mistake?—are capable of an easy answer in the abstract, the contexts in which they are created in the derivatives markets on trading floors by a number of different traders and account managers transacting with a variety of different forms of customer create very different problems. The role of the legal advisor in these contexts ought to be to address the manner in which financial institutions conduct the detail of their business (ensuring that traders, account managers, intermediaries and customers have a meeting of minds formed with free consent), as opposed to reliance on the mere existence of the protocols which may theoretically be in place within such institutions. The demeanour of witnesses, their credibility in front of a trial judge, and the impression of chaos which is frequently given by documentation trails of the sort in *Peekay v ANZ* is of course very important in litigation.¹²⁷ It is easy to forget, in the struggle to create mathematically complex products and legally exhaustive documentation, that simple matters such as good faith in transacting and clarity in the conduct of business will contribute both to the creation of effective contracts and as to credibility in the witness box (should matters reach that pitch).

The reversal by the Court of Appeal

The decision of Siberry QC was reversed by the Court of Appeal. In a nutshell, the Court of Appeal considered that Pawani was at fault for not having read the contract closely so as to notice that the nature of the product had changed, and consequently it was held that Peekay could not maintain an action for misrepresentation against ANZ. The Court of Appeal held, in essence, that the buyer should have read the documentation because if he had, as an "experienced investor", he would have realised that the nature of the product had changed.

The Court of Appeal focused on different aspects of the facts from the trial judge. The leading judgment was given by Moore-Bick L.J., with whom Collins J. concurred; with a short judgment in agreement being delivered by Chadwick L.J. It was considered to be significant by Moore-Bick L.J. that a five page risk disclosure statement had been included with the documentation sent to Pawani; that the original discussion between Balasubramaniam and Pawani contained merely a general description of the investment and not something which would ordinarily constitute a misrepresentation; that Pawani should have realised that this was a "derivative"; that it could be inferred (although there was no finding of fact to this effect) that Pawani would have understood the transaction better if he

¹²⁷ For further illustrations of this phenomenon see *The First National Bank of Chicago v Ackerley Communications Inc* 2001 US Dist LEXIS 20895 where the trial judge found the "straightforward testimony" of one party "infinitely more believable than the hedged and cagey answers given by" the other party. See also *Bankers Trust v Dharmala*, in relation to the defendant's employee who was considered to be honest and so unlikely to have made misrepresentations any more than "inadvertently".

contextual approaches advanced by Lord Hoffmann and followed by Lord Bingham. The latter approaches, with their preparedness to consider the background circumstances now constitute English law.⁴² The five principles set out by Lord Hoffmann in the House of Lords in *Investors Compensation Scheme v West Bromwich Building Society*⁴³ are considered in the next section.

The central principle in *Investors Compensation Scheme v West Bromwich Building Society*

- 8-36 The central principle in interpreting contracts under English law (at the time of writing) is generally taken⁴⁴ to be contained in the five-fold division of the principles contained in the judgment of Lord Hoffmann in the House of Lords in *Investors Compensation Scheme v West Bromwich Building Society* in the following terms:⁴⁵

"I think I should preface my explanation of my reasons with some general remarks about the principles by which contractual documents are nowadays construed. I do not think that the fundamental change which has overtaken this branch of the law, particularly as a result of the speeches of Lord Wilberforce in *Prenn v Simmonds*⁴⁶ and *Reardon Smith Line Ltd v Hansen-Tangen, Hansen-Tangen v Sanko Steamship Co*,⁴⁷ is always sufficiently appreciated. The result has been, subject to one important exception, to assimilate the way in which such documents are interpreted by judges to the common sense principles by which any serious utterance would be interpreted in ordinary life. Almost all the old intellectual baggage of 'legal interpretation' has been discarded. The principles may be summarised as follows.

- (1) Interpretation is the ascertainment of the meaning which the document would convey to a reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract.
- (2) The background was famously referred to by Lord Wilberforce as the 'matrix of fact', but this phrase is, if anything, an understated description of what the background may include. Subject to the requirement that it should have been reasonably available to the parties and to the exception to be mentioned next, it includes absolutely anything which would have affected the way in which the language of the document would have been understood by a reasonable man.
- (3) The law excludes from the admissible background the previous negotiations of the parties and their declarations of subjective intent. They are admissible only in an action for rectification. The law makes this distinction for reasons of practical policy and, in this respect only, legal interpretation differs from the way we would interpret utterances in ordinary life. The boundaries of this exception are in some respects unclear. But this is not the occasion on which to explore them.

⁴² See now, *Rainy Sky SA v Kookmin Bank* [2011] 1 W.L.R. 2900, Sup Ct.

⁴³ *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 All E.R. 98.

⁴⁴ *BCCI v Ali* [2001] 1 A.C. 251.

⁴⁵ *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 W.L.R. 896; [1998] 1 All E.R. 98 at 115.

⁴⁶ *Prenn v Simmonds* [1971] 3 All E.R. 237 at 240-242; [1971] 1 W.L.R. 1381 at 1384-1386.

⁴⁷ *Reardon Smith Line Ltd v Hansen-Tangen, Hansen-Tangen v Sanko Steamship Co* [1976] 3 All E.R. 570; [1976] 1 W.L.R. 989.

- (4) The meaning which a document (or any other utterance) would convey to a reasonable man is not the same thing as the meaning of its words. The meaning of words is a matter of dictionaries and grammars; the meaning of the document is what the parties using those words against the relevant background would reasonably have been understood to mean. The background may not merely enable the reasonable man to choose between the possible meanings of words which are ambiguous but even (as occasionally happens in ordinary life) to conclude that the parties must, for whatever reason, have used the wrong words or syntax (see *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd*).⁴⁸
- (5) The 'rule' that words should be given their 'natural and ordinary meaning' reflects the commonsense proposition that we do not easily accept that people have made linguistic mistakes, particularly in formal documents. On the other hand, if one would nevertheless conclude from the background that something must have gone wrong with the language, the law does not require judges to attribute to the parties an intention which they plainly could not have had. Lord Diplock made this point more vigorously when he said in *Antaios Cia Naviera SA v Salen Rederierna AB, The Antaios*:⁴⁹ if detailed semantic and syntactical analysis of words in a commercial contract is going to lead to a conclusion that flouts business common sense, it must be made to yield to business common sense."

This approach therefore sets out five core principles. The following sections consider their significance in relation to derivatives transactions.

The five principles as interpreted latterly

These five principles set out by Lord Hoffmann in *Investors Compensation Scheme* have been the subject of many judicial glosses in later cases. Each principle is considered in turn in the discussion to follow. Importantly, however, it has been suggested by Patten J. that these five principles should be taken together as a single whole and not treated as five distinct rules in themselves.⁵⁰ It is true that these five principles together constitute a guide as to the conduct of interpretation contracts but, nevertheless as will emerge from the discussion to follow, in many senses they must be considered separately.

(1) The perspective of the reasonable person

First, interpretation is conducted from the perspective of a reasonable person, albeit one who has knowledge of the circumstances in which the contract was created. Significantly, this demonstrates the underlying philosophy of the interpretation of contracts in English law: namely, an objective approach to identifying the meaning of the terms of the contract, as opposed to an attempt to identify the intentions of the parties. This concept has been expressed as the "familiar way of expressing the judicial process of inference from admissible primary evidence".⁵¹ It is not clear whether or not the reasonable person should

⁴⁸ *Mannai Investment Co Ltd v Eagle Star Life Assurance Co Ltd* [1997] 3 All E.R. 352; [1997] 2 W.L.R. 945.

⁴⁹ *Antaios Cia Naviera SA v Salen Rederierna AB, The Antaios* [1984] 3 All E.R. 229 at 233; [1985] A.C. 191 at 201.

⁵⁰ *HSBC Bank Plc v Liberty Mutual Insurance* [2001] All E.R. (D) 61.

⁵¹ *Zeus Tradition Marine v Bell* [1999] C.L.C. 391.

have expertise in derivatives, or simply be a reasonable member of the public. It is suggested that the reasonable person should be deemed to have the expertise of the buyer of the transaction that is the person whose level of expertise is likely to set the regulatory standard for the manner in which the transaction should have been conducted.

8-39 The concept of the reasonable person is interesting. The mythical reasonable person is necessarily shorn of any actual history or beliefs. When the parties to a contract act, they do so in the context of their personal circumstances. By contrast, the reasonable person is a cipher which is used to attempt to step away from the purely subjective attitudes and desires of two parties to litigation. Moreover, it is important to note that the reference to a reasonable person here does not get us beyond the fact that judges will also disagree as to the proper interpretation of a contract, which suggests that the reasonable person is not in truth a semantic superman but rather a reflection of the opinions of a given judge striving to be objective. However, what is useful about the reasonable person concept is that it reflects the fact that a written contract takes on a life of its own which is distinct from the human beings who created it. One looks first to the inanimate object that is the written contract in an attempt to discover meaning before consulting any of the human beings involved in its creation.⁵² The objective approach taken in English law to the interpretation of contracts is the apotheosis of this determination to see a contract as being a thing which is distinct from any of the human beings involved with its creation. In a perfect world, contractual positivists of this sort would simply deal with the wording of the contract; but, humans being what they are and it being in the essence of their natures to err, the wording of the contract cannot always be relied upon and so the courts are required to consider the background circumstances so as to identify the best interpretation of it.

(2) Reference to "absolutely anything" in the background circumstances

8-40 Secondly, (subject to what is said below) the background circumstances include "absolutely anything" which should have been reasonably available to the parties (whether it was or not).⁵³ In the abstract it would be unclear how far knowledge of the circumstances should extend; although the use of the expression "absolutely anything" (albeit that that has been qualified in subsequent cases) suggests that the buyer's commercial objectives would be significant to the extent they were made known to the seller, and also that the seller's wish to rely on the ordinary expectations of the derivatives markets as to the use of the terms at issue and the conduct of transactions in practice would be admissible.

8-41 What would be different between these two items, it is suggested, is the following. An inexperienced buyer might not have had any knowledge of normal market practice and that as such it ought not to be used to interpret the contract because of the inequality of bargaining power and expertise between the parties, whereas a transaction between market professionals would constitute a different context. (That they should be taken to constitute a different context is suggested by conduct of business regulation which differentiates between exactly those

⁵² See Lewison, *The Interpretation of Contracts*, 4th edn (London: Sweet & Maxwell, 2007), p.7.

⁵³ *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 W.L.R. 896; [1998] 1 All E.R. 98 at 115.

sorts of levels of expertise.)⁵⁴ By contrast, the buyer's commercial objectives in seeking a complex, bespoke derivatives product from an expert swaps dealer would necessarily have been of significance to the swaps dealer when constructing the product, as well as to the buyer; whereas, arguably, a high volume speculative derivative sold to another market professional by the seller might not require the seller to inquire into the buyer's objectives in the same way.

The effect of admitting "absolutely anything", and its subsequent restriction

8-42 As a result of the five principles in *Investors Compensation Scheme v West Bromwich Building Society* litigants and their advisors began to seek to adduce mountains of evidence relating to the circumstances in which their contracts had been created originally, with the effect that litigation became difficult to manage.⁵⁵ Once litigators felt that the floodgates had been opened to the admission of any evidence which went to the context in which the contract had been created, then litigation as to the interpretation of contracts became an even more document-heavy process than previously. Much of this difficulty could have been addressed simply by a development of the law of evidence relating to the admissibility of documents and other evidence between the terms of the contract itself. However, a large amount of judicial effort has been poured into re-calibrating Lord Hoffmann's central principles.

8-43 Lord Hoffmann's career on the bench was characterised by a series of brave attempts to introduce order to English law by restating some of its central principles in his judgments. Not infrequently this required his lordship to recalibrate his own words in later judgments in relation, for example, to the concept of "dishonesty" in equity⁵⁶ and the rights of minority shareholders in company law.⁵⁷ Similarly, his lordship was required to qualify this central principle in his lordship's own judgment in the later case of *BCCI v Ali*.⁵⁸ The gloss which Lord Hoffmann placed on this principle was as follows:

"When... I said that the admissible background included "absolutely anything" which would have affected the way in which the language of the document would have been understood by reasonable man, I did not think it necessary to emphasise that I meant anything which a reasonable man would have regarded as relevant. I was merely saying that there is no conceptual limits to what can be regarded as background. It is not, for example, confined to the factual background and can include the state of the law (as in cases in which one takes into account that the parties are unlikely to have intended to agree to something unlawful or legally ineffective) or proved common assumptions which were in fact quite mistaken. But the primary source for understanding what the parties meant is their language interpreted in accordance with conventional usage: '... we do not easily accept that people have made linguistic mistakes, particularly in formal documents'. I was certainly not encouraging a trawl through background which could not have made a reasonable person think that the parties must have departed from conventional usage."

⁵⁴ See para.17-07.

⁵⁵ Indeed the case management process under the Civil Procedure Rules became an important part of applying Lord Hoffmann's principles in practice by excluding inadmissible evidence.

⁵⁶ *Twinsectra v Yardley* [2002] 2 A.C. 164 followed by *Barlow Clowes v Eurotrust* [2005] UKPC 37.

⁵⁷ *Re Saul D Harrison & Sons Plc* [1995] 1 B.C.L.C. 14, followed by *O'Neill v Phillips* [1999] 2 All E.R. 961.

⁵⁸ *BCCI v Ali* [2002] 1 A.C. 251 at 269.

CHOICE OF LAW UNDER THE ROME CONVENTION: CONTRACTS CREATED ON OR BEFORE DECEMBER 17, 2009

The sources of law on contract in conflicts of law

10-12 This section relates to the choice of a governing law in a contract created on or before December 17, 2009. The Rome Convention deals with questions as to choice of the system of law which will govern a contract created within that time period. The discussion of many points of detail was therefore considered in the preceding section of this chapter. This section will focus on the key differences between the Convention and the Regulation in relation to choice of law in derivatives contracts.

10-13 The sources of conflict of law rules relating to contracts in England and Wales are in a state of flux at present. In essence, contracts created before December 17, 2009 are governed by the Rome Convention, as considered in this section of this chapter; whereas contracts created after December 17, 2009 are governed by the Rome I Regulation, as considered in the following section of this chapter. The change has been signalled by the introduction of the Rome I Regulation by the European Union which has updated the Rome Convention which had been in place previously. The changes are changes primarily of detail for the purposes of derivatives contracts, as set out below. Because the previous law will continue to apply to contracts created before the cut-off date, the previous law will be of importance to a large number of master agreements which will last for a number of years into the future and to confirmations of complex derivatives products with a long lifespan. Briefly put, the development of EU law in this area is part of the movement towards harmonisation of private international law rules within the European Union.

The legal architecture

10-14 In essence, the Rome Convention supplies the contractual choice of law provisions for the United Kingdom in relation to contracts which were created on or before December 17, 2009. The position relating to the governing law of contracts and the English conflicts of law rules was dealt with by the Contracts (Applicable Law) Act 1990 which incorporated expressly the Rome Convention 1980 and the Brussels Protocols of 1988 which amended it (referred to together as "the Convention"). The 1990 Act applies to disputes between legal jurisdictions within the United Kingdom, and in particular to "contractual obligations in any situation involving a choice between the laws of different countries".¹³ As such it stands for the whole of the English law rules relating to contracts in private international law on or before December 17, 2009.¹⁴ The policy goal of the Convention was the "sound operation of the internal market".¹⁵ As will emerge below, one of the regulation's key components is that "the

¹³ Rome Convention art.1(1).

¹⁴ On the detail of the Convention and generally see Collins et al., *Dicey & Morris on the Conflict of Laws*, 13th edn (London: Sweet & Maxwell, 2000), Ch.32 generally, p.1195 et seq.; Cheshire and North, *Private International Law*, 12th edn (London: Butterworths, 1992), p.457 et seq.

¹⁵ Council Regulation 44/2001 para.(1).

autonomy of the parties to a contract... must be respected" with the result that express choices of jurisdiction in a contract will be respected by the courts.

Competence ultimately to decide issues as to the interpretation of the Convention lies with the European Court of Justice ("ECJ"). Municipal courts are, however, only required to refer questions to the ECJ in circumstances in which they consider that there is a point of law at issue on which they require the ruling of the ECJ. However, in reaching their own decisions, municipal courts are required to act "in accordance with the principles laid down by, and any relevant decision of [the ECJ]".¹⁶ There is similarly an obligation to effect a uniform application of the Convention across the EU rather than simply applying the old English common law rules.¹⁷

The scope of the Rome Convention

Article 1(1) of the Rome Convention provides that "The rules of this Convention shall apply to contractual obligations in any situation involving a choice between the laws of different countries". Therefore, the first issue is to demonstrate that the dispute is contractual in nature.¹⁸ The issue raised must not be tortious or restitutionary for the Convention to apply, as those types of remedy are considered generally in Ch.7. Unlike the Rome Convention, the jurisdiction regulation is not restricted in scope to contractual disputes and therefore may refer to issues properly concerned with contract or alternatively with tort, equity or restitution.

As mentioned above, there must be a choice of law problem for the provisions of the Rome Convention to apply. Traditionally this issue arose at common law where the contract was effected with a party from another jurisdiction, or the contract was formed in another jurisdiction, or the contract had some connection with another jurisdiction which brought a different system of law into play. Given the concretisation of the issue in statutory form some further issues arise. First, by way of example, where French entities contracting in France enter into a contract but one of those institutions then books the transaction through an English subsidiary, the issue arises whether or not there is any scope for English law to apply. Secondly, the requirement that there must be "a choice between the laws of different countries" does not apply to purely procedural or evidential matters between the parties.¹⁹ Thirdly, the reference specifically to "country" and not to "system of law" means that the laws of, for example, individual US states would not fall within the Convention as not relating to distinct countries²⁰ but only to regions within a country.

The Rome Convention excludes a number of forms of contract, such as non-commercial contracts, wills and employment contracts.²¹ However, financial derivatives contracts fall within its ambit. Importantly, issues of the status or legal capacity of natural persons falls out with the Rome Convention.²² Similarly,

¹⁶ Section 3(1) of the 1990 Act.

¹⁷ Rome Convention art.18.

¹⁸ See for example *Kleinwort Benson v Glasgow CC* [1997] 4 All E.R. 641 HL.

¹⁹ Rome Convention art.1(2)(h).

²⁰ However, Cheshire and North take the view that the Convention may be applicable in such situations in, *Private International Law*, 12th edn (London: Butterworths, 1992), p.469.

²¹ Rome Convention art.1(2)-(4).

²² Rome Convention art.1(2)(a).

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arbitration agreements and agreements as to jurisdiction are excluded from the Rome Convention.²³ As a result of the Anglo-centric nature of the trust, trusts are excluded although issues as to contracts entered into by trustees would appear to be included within the Rome Convention.²⁴ The English common law rules are only of application to cases which do not fall within the Convention or to contracts effected before the Rome Convention came into force.²⁵ The Rome Convention does apply to disputes between parties within the United Kingdom, and therefore traditional conflict of law rules will apply in relation to claims about contracts effected for example between England and Scotland.²⁶

THE APPLICABILITY OF THE ROME CONVENTION

- 10-19 Article 2 provides that: "Any law specified by this Convention shall be applied whether or not it is the law of a Contracting State." Therefore, the Convention is to have universal application and is not restricted to the application of the legal systems of Member States. For example, the parties would be free to choose the law of New York, and are thus not restricted to choosing European systems of law.

Issues relating to choice of law

- 10-20 The primary distinction for the lawyer preparing financial documentation is between contracts where there is an express choice of law and situations where there is no such express choice of law. As considered above, in master agreements, confirmations and credit support agreements, it is usual to specify a particular system of rules which are to govern the contract so that any disputes which arise in relation to that contract are resolved by reference exclusively to that particular system of law. It is also usual to identify a choice of jurisdiction and a choice of arbitration to deal with problems arising under that contract. Clearly, a choice of law provision adds certainty to the parties' agreement by pre-selecting the treatment of any particular problems which might arise through their agreement. However, there are a number of situations in which no master agreement will have been signed or no confirmation is in place, such that the parties are thrown back on core principles of the conflict of laws to decide the appropriate rule to govern their agreement.²⁷ In this latter category of circumstance, the Rome Convention will interpolate a governing law for the contract.

²³ Rome Convention art.1(2)(a).

²⁴ Rome Convention art.1(2)(g). It would appear therefore that the exclusion relates specifically to the inter-relationship of settlor, trustee and beneficiary.

²⁵ There is also some residual application for matters such as the Unfair Contract Terms Act 1977.

²⁶ Section 2(3) of the 1990 Act.

²⁷ cf. paras 10-24, 10-39.

Express choice of law

Where the parties make an express choice of law, art.3 of the Rome Convention provides that "a contract shall be governed by the law chosen by the parties".²⁸ Thus the contracting parties are at liberty to select any system of law they wish.²⁹ It is no objection to such a choice of law that the system of law chosen has no other connection with the subject matter of the contract.³⁰ This principle is now accepted in European Union law, and not simply in English common law,³¹ and has also gained acceptance in the United States of America, despite a history of resistance in all of these jurisdictions at some point.³² So, parties to a derivatives contract which is denominated in euros and contracted between Belgian and Spanish parties through offices in Brussels and Madrid respectively may nevertheless be validly subject to an English governing law if the parties expressly select English law as their governing law. This is referred to in the literature as "party autonomy" in that the parties have complete freedom as to their choice of law.³³

An express choice of law is made where the parties use words such "this contract is governed by" or "this contract is to be construed in accordance with" or "this contract is subject to" whichever system of law is intended.³⁴ In the ISDA Master Agreement the schedule invites the parties to insert their chosen governing law on the appropriate dotted line, which will constitute an effective choice of governing law.

The parties are also entitled to alter their choice of law at any time during the course of the agreement.³⁵ The Convention is only concerned in art.3 with the selection of the applicable law. What it does not seek to deal with is a contract which selects a particular system of law to be its governing law and also incorporates expressly some provisions of another system of law to deal with a specific issue. This incorporation of different terms does not invalidate the underlying choice of law. Rather, it selects the governing law and requires that governing law to apply certain contractual terms which are drawn from a different system of law.³⁶

²⁸ Rome Convention art.3(1). At common law see *Whitworth Street Estates (Manchester) Ltd v James Miller and Partners Ltd* [1970] A.C. 583 at 603, per Lord Reid.

²⁹ For an account of the development of this principle, see *Dicey and Morris on the Conflict of Laws*, 13th edn (London: Sweet & Maxwell, 2000), p.1216 et seq.

³⁰ *Vita Foods Products Inc v Unus Shipping Co Ltd* [1939] A.C. 290.

³¹ Under the common law before the 1990 Act, the court would have applied "the ordinary rules of English law relating to the construction of contracts": *Compagnie Tunisienne de Navigation SA v Compagnie d'Armement Maritime SA* [1971] A.C. 572 at 603.

³² See *Dicey and Morris on the Conflict of Laws*, 13th edn (London: Sweet & Maxwell, 2000), para.32-060 et seq.

³³ See Collins et al, *Dicey & Morris on the Conflict of Laws*, 13th edn (London: Sweet & Maxwell, 2000), para.32-060.

³⁴ *Helbert Wagg & Co Ltd, Re* [1956] Ch. 323 at 340.

³⁵ Rome Convention art.3(2).

³⁶ See Cheshire and North, *Private International Law*, 12th edn (London: Butterworths, 1992), p.482.

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into complex derivatives with JP Morgan.¹¹⁴ It was a novice entity in the use of derivatives. The parties executed a 2002 version ISDA Master Agreement together with a 60-page Confirmation. The effect of the collapse of Lehman Brothers in September 2008 was to affect the amounts owed by the authority to an enormous degree, with the result that JP Morgan sought an amount of US \$112 million from the authority under the transaction. The first issue to arise was whether jurisdiction should be granted to the English courts, as was provided for in the parties' master agreement, or whether it should be granted to the Berlin Regional Court as the transport authority preferred. The authority argued that art.23 of the Brussels I Regulation should be displaced by art.22 on the basis that this case fell within the exclusive jurisdiction provisions in that article, which thus operated as an exception to the usual rule that jurisdiction would follow an express choice of jurisdiction clause. It was held by Tease J.¹¹⁵ that the general provision in art.23 of the Brussels Convention applied to the parties because none of the specific exclusions in art.22 applied. The Court of Appeal upheld the decision of Tease J. on the basis that the issues with which the court was "principally concerned" in this case were connected with the claim before the English courts and not matters covered by art.22.¹¹⁶

10-71 Similarly in *UBS AG, London Branch v Kommunale Wasserwerke Leipzig GmbH*¹¹⁷ it was argued that art.22 meant that the issue should be remitted to the German courts. On those facts it was also argued that because the Leipzig water authority had allegedly not acquired proper internal authorisation as required by German law for a complex combination of credit default swap and CDO products, which were intended to provide protection against the failure of certain counterparties to perform their obligations to the authority, that the contract was null and void. It was held that because the proceedings were "principally concerned" with the enforceability of the derivatives agreements under English law and not with questions of German law as to authority and capacity, then the proceedings could proceed under English law.

10-72 It is suggested that both of these cases are unfortunately decided. In both instances the claimant is operating a very old argument indeed. In terms that argument runs as follows: I now realise that I have made a bad bargain, and so I am going to have that bargain set aside on the basis that I did not follow my own internal procedures for acquiring authority to make that bargain in the first place. There is a logically anterior question to the issue of interpreting the contract: that logically anterior question is whether or not the parties had the necessary capacity to make that contract in the first place. So, there can be no question as to the efficacy of the contract under English law or before an English court until an answer has been found to the question as to whether or not the claimant had either

¹¹⁴ The product was an "Independent Collateral Enhancement Transaction" which combined a contract granting credit risk protection in respect of cross-border lease arrangements that the authority had previously concluded with third parties with an interest rate swap.

¹¹⁵ *JP Morgan Chase Bank NA v Berliner Verkehrsbetriebe (BVG) Anstalt Des Öffentlichen Rechts* [2009] EWHC 1627 (Comm).

¹¹⁶ In particular art.22(2) which provides that: "in proceedings which have as their object the validity of the constitution, the nullity or the dissolution of companies or other legal persons or associations of natural or legal persons, or of the validity of the decisions of their organs, the courts of the Member State in which the company, legal person or association has its seat. In order to determine that seat, the court shall apply its rules of private international law."

¹¹⁷ *UBS AG, London Branch v Kommunale Wasserwerke Leipzig GmbH* [2010] EWHC 2566 (Comm); [2010] All E.R. (D) 176 (Oct).

the authority or the capacity to enter into that agreement in the first place. If the authority did not have the capacity to enter into that agreement, then there is no contract to enforce before the English court because it is void ab initio, as with the UK local authority swaps cases.¹¹⁸ Therefore, jurisdiction to decide this fundamental question should have been granted to the German courts.

Article 22 also arose for analysis in *Depfa Bank Plc v Provincia Di Pisa*¹¹⁹ where an Italian local authority had entered into interest rate swaps to cap the interest rate payments on its publicly issued debt. The interest rate swaps were documented under an ISDA Master Agreement. Latterly, the authority sought to argue that the transaction was void as being beyond the powers of the authority. The two banks which had sold the interest rate swaps sought to enforce the authority's payment obligations. The issue arose whether the appropriate jurisdiction was England and Wales (as identified in the master agreement) or Italy (as the Italian local authority preferred). It was held that this was not a case in which the issues could only be decided by reference to Italian law but rather that the interests of justice would not be served by a trial in Italy. Moreover, declining jurisdiction in favour of the Italian Administrative Court would not have promoted the interests of justice because proceedings on the substance of the contract would need to continue in England, and the jurisdiction of the Italian court under Italian law only permitted it to hear some (but not all) of the issues in this case.

Express choice of jurisdiction binding only between the parties to the contract

In *Morgan Stanley & Co International Plc v China Haisheng Juice Holdings Co Ltd*,¹²⁰ the claimant bank sought to rely on a provision in cl.13 of the ISDA Master Agreement, a clause which provided that England and Wales was the sole jurisdiction for the resolution of disputes in relation to currency swaps (and other derivatives) effected between the parties to that master agreement. The claimant sought to rely on that clause in relation to obligations of an affiliate of its counterparty, even though that affiliate was not itself a party to the master agreement. On these facts, it was held that it had not been the intention of the parties that cl.13 was to apply to transactions with persons which were not parties to the master agreement.¹²¹ It had been argued that because there were references to "Affiliates" in the Schedule, in relation to cross-default, set-off in case of insolvency, and so forth, that the affiliate and the counterparty should be treated as being a single business entity, with the result that the affiliate should be deemed to be subject to the jurisdiction of the English courts under cl.13. This argument was rejected. It was held that on a proper interpretation of cl.13 it was intended to apply only to claims between the parties and only claims relating to the master agreement.¹²²

¹¹⁸ *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] A.C. 669.

¹¹⁹ *Depfa Bank Plc v Provincia Di Pisa* [2010] EWHC 1148 (Comm).

¹²⁰ *Morgan Stanley & Co International plc v China Haisheng Juice Holdings Co Ltd* [2009] EWHC 2409 (Comm); [2011] 2 B.C.L.C. 287.

¹²¹ *Credit Suisse First Boston (Europe) Ltd v MLC (Bermuda) Ltd* [1999] 1 All E.R. (Comm) 237 applied; *Donohue v Armco Inc* [2002] 1 All E.R. (Comm) 97 considered.

¹²² The decision of Rix J. in *Credit Suisse First Boston (Europe)* [1999] 1 All E.R. (Comm) 237 was applied in this sense. As was explained in Ch.2, mention of the affiliate in the Schedule was only as part of establishing the circumstances in which the counterparty could be treated as being subject to

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Express choice of jurisdiction in an arbitration clause

- 10-75 In *Bankers Trust Co v PT Jakarta International Hotels and Development*,¹²³ two companies in the Bankers Trust group of companies entered into several cross-currency swaps with the respondent, an Indonesian company. These transactions were governed by a 1992 edition ISDA Master Agreement, with an express choice of English law as the governing law. In the event of any dispute, the master agreement provided that all disputes arising out of the contract or being connected to that contract were to be decided by arbitration in London. The respondent failed to make payment under those derivatives transactions and latterly commenced proceedings against the Bankers Trust companies in Indonesia. The Bankers Trust companies commenced arbitration proceedings in London and they also applied for an injunction to stay the Indonesian action on the basis that it was in breach of the arbitration clause in the master agreement. It was held by Cresswell J. that an applicant for such an injunction seeking restraint of foreign proceedings had to demonstrate with a high degree of probability that its case was a good one, and that its application had been brought promptly and before the foreign proceedings had become too far advanced. On these facts, it was found that the Bankers Trust companies had brought their application in good time and that the arbitration clause covered all of the disputes between the parties with the result that there was no good reason to refuse to grant the injunction.¹²⁴ Among the powerful reasons which his Lordship identified in favour of the grant of an injunction was the need to give effect to the arbitration clause so as to avoid undermining the worldwide market in swaps and derivatives which the court considered at that time to be in its infancy.

No express choice of jurisdiction

- 10-76 Where there is no express choice of jurisdiction, as set out above,¹²⁵ the place of performance is the place where issues should be heard. Where there is more than one defendant in different jurisdictions, issues shall be heard in the place where any one of them is domiciled.¹²⁶ This general rule is qualified by a requirement that the claims are "so closely connected that it is expedient to hear and determine them together to avoid the risk of irreconcilable judgments resulting from the same proceedings".¹²⁷ However, it has been held in the wake of the collapse of Enron, that where the parties' contract contains a term which is not exclusive as to jurisdiction and which contemplates the bringing of proceedings simultaneously in different jurisdictions by providing that the parties waived any right to object to a challenge to the jurisdiction of the English courts, then it would be

an event of default, or entitled to set-off under a netting agreement, and so forth under the master agreement; but it did not make the affiliate a party to the master agreement itself.

¹²³ *Bankers Trust Co v PT Jakarta International Hotels and Development* [1999] 1 All E.R. (Comm) 785.

¹²⁴ *Bankers Trust Co v PT Mayora Indah* Unreported January 20, 1999 applied. See also *Aggeliki Charis Cia Maritima SA v Pagnan SpA, The Angelic Grace* [1995] 1 Lloyd's Rep. 87; *Toepfer International GmbH v Societe Cargill France* [1997] 2 Lloyd's Rep. 379; *Shell International Petroleum Co Ltd v Coral Oil Co Ltd* [1999] 1 Lloyd's Rep. 72.

¹²⁵ See para.10-16.

¹²⁶ EC 44/2001 art.6(1).

¹²⁷ EC 44/2001 art.6(1).

neither in breach of contract nor vexatious for one of the parties to seek to bring proceedings in a second jurisdiction after they had already been commenced by the other party in the first.¹²⁸

No application of the forum non conveniens principle

10-77 It was the case under English law that a litigant could apply to the court for an order that the jurisdiction selected was a forum non conveniens: in essence, that meant that the applicant had to convince the court that the jurisdiction selected or applied by law was sufficiently inconvenient that it should be displaced.¹²⁹ It has been held, however, in applying art.4 in *Owusu v Jackson*¹³⁰ that the forum non conveniens principle does not apply after the enactment of the Convention and latterly the Regulation.¹³¹ Significantly, that is so even in relation to litigation between an English party and a Jamaican party which has no relation to the European Union or any likely effect on the completion of the single market. However, the strictness of the principles in the Regulation is absolute in this regard. Indeed, as Prof Briggs has observed:

"Quite why the Regulation provides a stay of English proceedings in favour of the courts of Jamaica is puzzling ... But civilian hostility to the doctrine of *forum non conveniens* can seem almost pathological."¹³²

Recognition of judgments

10-78 Significantly, any judgment given in one Member State shall be recognised in any other Member State without the need for further action.¹³³ The only circumstances in which judgments are not to be recognised is where it would be "manifestly contrary to public policy", where judgment was given in default of the respondent's appearance in court where no copies of proceedings were delivered to the respondent, where it is irreconcilable with existing judgments, or where it is irreconcilable with a dispute between those same parties which is already in train.¹³⁴ However, the Regulation contains a general principle that "under no circumstances may a foreign judgment be reviewed as to its substance".¹³⁵

¹²⁸ *Royal Bank of Canada v Coöperatieve Centrale Raiffeisen-Boerenleenbank BA* [2004] EWCA Civ 07; [2004] 2 All E.R. (Comm) 847.

¹²⁹ It was held by Lord Goff in *Spiliada Maritime Corp v Cansulex Ltd* [1987] A.C. 460 at 476 that "The basic principle is that a stay will only be granted on the grounds of forum non conveniens where the court is satisfied that there is some other available forum, having jurisdiction, which is the appropriate forum for trial of the action, i.e. in which the case may be tried more suitably for the interests of all the parties and the end of justice". This principle was applied in *Connelly v RTZ Corp Plc* [1998] A.C. 854 HL and in *Lubbe v Cape Plc* [2000] 1 W.L.R. 1545 HL.

¹³⁰ *Owusu v Jackson* Case C-281/02, [2005] E.C.R. I-9337.

¹³¹ cf. *Re Harrods (Buenos Aires) Ltd* [1992] Ch. 72.

¹³² Briggs, "Private International Law" in Burrows (ed.), *Private Law*, 2nd edn (Oxford: Oxford University Press, 2007) p.1551.

¹³³ EC 44/2001 art.33(1).

¹³⁴ EC 44/2001 art.34.

¹³⁵ EC 44/2001 art.36.

- 12-85 There is one final issue as to the role of the custodian of the global note as a trustee in itself. A trustee may or may not be appointed in respect of the global note. Further, the custodian may not be expressed to be a trustee and yet appear to have the trappings of a trustee in a jurisdiction where the trust concept is not recognised. The issue as to the enforceability of trustee obligations is therefore a vexed one. This issue arises generally with reference to bond issues and in particular in respect of depositary receipts.¹⁷⁷

Shortcomings in standard market documentation for collateral

- 12-86 The discussion of the ISDA Credit Support Deed identified a number of deficiencies in the description of the nature of the rights which the secured party acquires: see in particular in paras 12-44, 12-45, 12-47 and 12-49. There are other problems, however. The impact of the decision in *Westdeutsche Landesbank Girozentrale v Islington LBC*¹⁷⁸ is that—even though it was accepted that the parties would have expected to receive compound interest on their money in ordinary circumstances and that they had entered into the standard form contracts—parties to financial contracts will not be entitled to proprietary remedies where those agreements are held to be void. Furthermore, it appears from the decisions that any contractual provision which sought to preserve such proprietary rights would itself be void, making the retention of title in such agreements impossible.
- 12-87 Therefore, the key problem with the decision in *Westdeutsche Landesbank Girozentrale v Islington LBC* and all of the other local authority swaps cases is that the courts intentionally overlook the fact that the parties had allocated the risks of their transactions. Leggatt L.J. considers that there is no substantive issue to consider on the facts of *Westdeutsche Landesbank Girozentrale v Islington LBC* when he held that:

“The parties believed that they were making an interest rate swaps contract. They were not, because such a contract was ultra vires the local authority. So that they made no contract at all.”¹⁷⁹

Therefore, the courts made no reference at all to any of the contractual terms agreed between them. The result of this refusal to consider the standard market contracts will include those terms dealing with credit risk management, as well as terms dealing with the creation of commercial interest rate swap obligations. Therefore, the further question arises: would a guarantee or collateral agreement be valid if it were annexed to that contract? That is, would the banks have been able to enforce the terms of any guarantee extended to them by the local authorities? It would follow from the courts’ insistence that the contracts are to be ignored, that any credit support document attached to the interest rate swap agreement would be similarly void. Therefore, if the local authorities had ring-fenced a particular bank account with an amount of money in it, held on trust for the banks contingent on the authorities’ failure to perform under the main agreement, the banks would have had no recourse to that money because the

¹⁷⁷ See Benjamin, *The Law on Global Custody* (London: Butterworths, 1996), p.41 et seq.

¹⁷⁸ *Westdeutsche Landesbank Girozentrale v Islington LBC* [1996] A.C. 669.

¹⁷⁹ *Westdeutsche Landesbank Girozentrale v Islington LBC* [1994] 4 All E.R. 890 at 967.

agreement creating the trust would be unenforceable as being void ab initio. Therefore, a collateral agreement would be unenforceable unless it was created at arm’s length from the master agreement and any confirmation to enable it to survive as a free-standing arrangement.

Given the decision of the House of Lords (which was unanimous on this point) that there was no ground for the banks having a proprietary interest in any property held by the local authorities, the logical conclusion of their reasoning is that there would have been no way in which the banks could have reserved to themselves any proprietary interest in the money paid to the local authorities by means of either the master agreement or any other document incorporated into it in the standard market format.

Prof Martin joined that camp of commentators who consider that the bank was satisfied on the facts of that case to pass title in the deep discount payment absolutely to Islington while at the same time considering that the bank “had been prepared to take the risk of insolvency”.¹⁸⁰ There was, of course, no intention to take that risk in the absence of effective netting provisions. The result is that property in the money passes even though the contract is void. This efficacy of the contract would appear to be in support of the original purpose of the contract, rather than returning the full property in the money to the bank to negate the commercial effect of the transaction.

The salutary lesson for those attempting to create collateral arrangements is therefore to attempt to achieve their goal in a context which permits the collateral structure to be free-standing and not bound into the void master agreement and confirmations. This is a direct abnegation of the principle of achieving single agreements through a credit support annex which is propounded by ISDA.¹⁸¹ However, it is contended that the contracting party must choose between an attempt to manage the risk of counterparty insolvency by achieving broad close-out netting under a single, all-enveloping master agreement, and a viable collateral structure which will manage credit risk by retaining proprietary rights in some specified category of assets even though the master agreement is held to be void.¹⁸²

Insolvency and collateral

An issue arises in relation to insolvency of one of the parties to a derivatives transaction as to whether the collateral agreement may be enforced. If the collateral structure were effected in the form of a trust then the trust would take effect regardless of the insolvency of the party acting as trustee of it.¹⁸³ Otherwise in relation to personal collateral arrangements and other collateral arrangements which do not automatically accord effective proprietary rights on the secured party, the Settlement Finality Regulations 1999,¹⁸⁴ which are considered in detail

¹⁸⁰ Martin, *Hanbury and Martin’s Modern Equity*, 14th edn (London: Sweet & Maxwell, 1999), p.665.

¹⁸¹ See para.2-14.

¹⁸² See Hudson, “Proprietary rights in financial transactions” (1998) 4 *Amicus Curiae* 9.

¹⁸³ *Re Kayford* [1975] 1 WLR 279.

¹⁸⁴ The Financial Markets and Insolvency (Settlement Finality) Regulations 1999, SI 2979/1999.

liabilities can be taken into account but scope must be left for the possibility that the company will be able to find the wherewithal to meet those obligations before they become due and payable.

13-43

Section 123 of the Insolvency Act 1986 provides, to the extent that it is relevant for present purposes, as follows:

- “(1) A company is deemed unable to pay its debts—
- (a) if a creditor (by assignment or otherwise) to whom the company is indebted in a sum exceeding £750 then due has served on the company, by leaving it at the company’s registered office, a written demand (in the prescribed form) requiring the company to pay the sum so due and the company has for 3 weeks thereafter neglected to pay the sum or to secure or compound for it to the reasonable satisfaction of the creditor, or
 - (b) if, in England and Wales, execution or other process issued on a judgment, decree or order of any court in favour of a creditor of the company is returned unsatisfied in whole or in part, or
 - (c) if it is proved to the satisfaction of the court that the company is unable to pay its debts as they fall due.
- (2) A company is also deemed unable to pay its debts if it is proved to the satisfaction of the court that the value of the company’s assets is less than the amount of its liabilities, taking into account its contingent and prospective liabilities.”

Lord Neuberger in the Court of Appeal in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc*⁷⁹ approved the characterisation of s.123(1) as being a “cash flow test” (in which the measure of the solvency of the entity depends upon its ability to meet its obligations from its cash flow) and s.123(2) as being a “balance sheet test” (in which the obligations rest on a measurement of the entity’s structural assets and liabilities as valued at the time of creating the balance sheet account). This allows a balance to be struck between an entity’s present and future liabilities on the one hand and its present and likely future wherewithal to meet those liabilities.

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The market situation at the time of the collapse of Lehman Brothers in September 2008 is instructive here. Before the “credit crunch” (in which banks stopped lending to one another and stopped lending to their customers at anything like normal levels) began to gather momentum, most financial institutions had been able to book optimistic values for their assets (particularly in the form of securities and derivatives); but as the credit crunch bit then previously profitable instruments like collateralised debt obligations (“CDO”, as described in Ch.1),⁸⁰ credit default swaps (“CDS”) and real estate investments in the USA had to be devalued sharply. In particular, if a special purpose vehicle (“SPV”) which was used in the construction of a CDO structure, which in turn was rated at AAA due to the perceived quality of the CDO product which that SPV operated, then once the value of that CDO deteriorated in value there was a question as to whether or not the SPV remained solvent given the question as to whether or not it would be able to meet its future obligations to the investors in the CDO. This is particularly

⁷⁹ *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2011] Bus. L.R. 1359; [2011] 1 W.L.R. 2524.

⁸⁰ See para.1-189.

so if an established institution which is providing credit support for the transaction itself collapses or sees a deterioration in its credit worth.

The decision of Morritt C. in *BNY Ltd v Eurosail Plc*⁸¹ concerned just such a CDO. This transaction was another casualty of the Lehman Bros collapse in September 2008. In essence, the transaction was guaranteed by Lehman Bros subsidiaries and so the claimants sought to have the entity which issued the bonds under the CDO declared insolvent. The issue in this particular appeal concerned the difficult question whether or not the issuer was insolvent. Specifically it revolved around whether or not future obligations to make payment rendered that entity insolvent if at the time of taking the valuation that entity would not have been able to meet them. Of particular significance in relation to s.123 of the Insolvency Act 1986 in establishing whether or not an entity is insolvent is para.(d) which requires the court to take “into account [that entity’s] contingent and prospective liabilities”.

13-45

Previously, Nicholls L.J. had posited an example in *Byblos Bank SAL v Al-Khudhairy*⁸² in relation to s.223 of the Companies Act 1948 (since repealed) of a company which had £10,000 in assets and a future obligation to repay a loan of £100,000, and had held that “when taking into account its future liabilities, such a company does not have the present capacity to pay its debts and as such it ‘is’ unable to pay its debts”.⁸³ What this approach does not consider is whether or not that entity would be able to raise the £90,000 difference in the time between the date of valuation and the date of required payment. Under different legislation in 1869, it had been held in *Re European Life Assurance Society*⁸⁴ that the reference a company’s “debts” was a reference to debts which were actually due at the time when the valuation was taken. So, when Briggs J. considered the Insolvency Act 1986 in *In Re Cheyne Finance Plc (No.2)*⁸⁵ in the context of when the debts must become due, his lordship held that he was not bound by the judgment of Nicholls L.J. because the 1986 Act relates to balance sheet liability in which the court is not limited to the entity’s “present” ability to meet its obligations.

13-46

So, in *BNY Ltd v Eurosail Plc*⁸⁶ Morritt C. considered he was not bound by the approach of Nicholls L.J. because that related to different legislation and that taking into account the contingent and prospective liabilities of the entity did not require his lordship simply to base his approach on a “commercially illogical” face value of those future or contingent obligations⁸⁷ (because those values could vary over time and because the present value of an instrument differs from the value of waiting for its maturity (due to the “time value of money”⁸⁸)). In consequence, on the facts it was held that because there was no obligation to bring into account the face value of the future obligations of the SPV in relation to payments under the CDO then the SPV was not insolvent at the material time.

13-47

⁸¹ *BNY Ltd v Eurosail Plc* [2010] EWHC 2005 (Ch); [2010] Bus. L.R. 1731

⁸² *Byblos Bank SAL v Al-Khudhairy* [1987] B.C.L.C. 232.

⁸³ *Byblos Bank SAL v Al-Khudhairy* [1987] B.C.L.C. 232 at 247.

⁸⁴ *Re European Life Assurance Society* (1869) L.R. 9 Eq. 122.

⁸⁵ *Re Cheyne Finance Plc (No.2)* [2008] Bus. L.R. 1562 at [30] et seq.

⁸⁶ *BNY Ltd v Eurosail Plc* [2010] EWHC 2005 (Ch); [2010] Bus. L.R. 1731

⁸⁷ *BNY Ltd v Eurosail Plc* [2010] EWHC 2005 (Ch); [2010] Bus. L.R. 1731 at [31].

⁸⁸ Where the “time value money of money” refers to the mathematical, financial theory that, for example, being paid £5 immediately is worth something different from a promise to pay £5 in one year’s time.

Whereas, if those future obligations had been brought into account at that time at their face value then the entity would have been insolvent.

13-48

It is suggested that the issue here is as to the drafting of the event of default relating to the bankruptcy of the relevant entity. On the basis of the judgment of Morritt C. then an event of default drafted on the basis that the entity would be deemed to be insolvent if it "could not pay its present, contingent and future obligations as they become due" then the claimant creditor could not rely on the face value of those liabilities being taken into account. To pray in aid the approach taken by Nicholls L.J. above, the clause would need to provide that the entity would be deemed to be insolvent if "its assets at any valuation date are lower in value than the aggregate of its present, contingent and future obligations as if they were due and payable on that valuation date". The difference is that in the second provision the creditor is entitled to take the current value of those liabilities into account as though the counterparty was required to meet all of those obligations immediately. But for the extension in s.123(2) of the 1986 Act, it is suggested, that it would be illogical to claim that an entity would not be able to meet its obligations as they become "due and payable" because future obligations are not "due and payable" until their maturity date. In relation, for example, to an annual payment date on an interest rate swap, that would not be "due and payable" until the payment date arrives. Therefore, to bring that future obligation into account would require a provision to that effect and it would also require a present valuation of the likely value of that swap on the future payment date which records that the counterparty is expected to be liable to make a payment of a given amount: of course, it may be the case that on that payment date that the counterparty benefits from movements in interest rates in the meantime which mean that it has no obligation (or only a small obligation) to make payment. Clearly, it would require clear proof that such a contingent obligation is likely to fall in at a level which would force the counterparty into insolvency and that that counterparty would not be able to raise sufficient funds to meet that obligation.

13-49

This matter was appealed to the Court of Appeal in *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc*⁸⁹ who approved the judgment of Morritt C. One significant point which was made in the Court of Appeal was that the purpose of s.123(2) of the 1986 Act was to deal with entities with incurable problems with future or contingent debts: this meets the point made above that an entity may be able to find sufficient funds to meet a future obligation even if it is not in funds at the time of valuing its assets and liabilities. Therefore, the question was whether or not that entity could reasonably be expected to meet its obligations.

The question of bank insolvency under the Banking Act 2009

Bank insolvency in general terms

13-50

Part 2 of the Banking Act 2009 deals with bank insolvency. One of the great difficulties with the global financial crisis in 2008–2009 was deciding whether banks were insolvent or whether they were solvent but dealing in an illiquid

⁸⁹ *BNY Corporate Trustee Services Ltd v Eurosail-UK 2007-3BL Plc* [2011] Bus. L.R. 1359; [2011] 1 W.L.R. 2524.

market which made it seem temporarily as though they would have been unable to meet their debts as they would in time fall due. Section 90 gives an overview of the insolvency process under Pt 2 of the Banking Act 2009 as follows:⁹⁰

- "(2) The main features of bank insolvency are that—
- (a) a bank enters the process by court order,
 - (b) the order appoints a bank liquidator,
 - (c) the bank liquidator aims to arrange for the bank's eligible depositors to have their accounts transferred or to receive their compensation from the FSCS,
 - (d) the bank liquidator then winds up the bank, and
 - (e) for those purposes, the bank liquidator has powers and duties of liquidators, as applied and modified by the provisions of this Part."

In the first place there must be a court order made for the insolvency process to begin⁹¹ which must be made on an application from the FSA, the Bank of England or the Treasury.⁹² A liquidator is to be appointed with a view to liquidating the assets of the insolvent bank. To demonstrate insolvency, three particular grounds must be satisfied:⁹³

- "(3) Ground A is that a bank is unable, or likely to become unable, to pay its debts,
- (b) Ground B is that the winding up of a bank would be in the public interest, and
 - (c) Ground C is that the winding up of a bank would be fair."

So, first, the bank must either be unable to pay its debts or unlikely to be able to pay its debts. Two problems arise here: a bank can be treated as insolvent if it is considered "unlikely" that it will be unable to pay its debts, which raises problems as to the level of likelihood and whether that means a likelihood of a failure across the life of the debt or in the immediate future; and also that the bank must be "unable to pay its debts" possibly at any time and not (as the legend ordinarily has it) when the bank is "unable to pay its debts as they become due". Secondly, it must be in the public interest that the bank is wound up. Thirdly, the winding up must be "fair". Furthermore, the threshold conditions set out in s.7 of the Banking Act 2009 must also be satisfied, as set out above. If those conditions are satisfied, then an insolvency order may be made further to s.98 of the Banking Act 2009 where the FSA has given notice under s.120 of the Banking Act 2009 (for an application for an administration order or a petition for winding up order) and the FSA or the Bank of England applies for a bank insolvency order, then the insolvency order "is treated as having taken effect when the application or petition was made or presented".⁹⁴

A bank liquidator is then appointed in accordance with the Bank Insolvency (England and Wales) Rules 2009.⁹⁵ The insolvent bank is then liquidated in accordance with the objectives set out in s.99 of the Banking Act 2009:

13-51

⁹⁰ Banking Act 2009 s.90(2).

⁹¹ Banking Act 2009 s.94.

⁹² Banking Act 2009 s.95.

⁹³ Banking Act 2009 s.96(1).

⁹⁴ Banking Act 2009 s.98(2).

⁹⁵ Bank Insolvency (England and Wales) Rules 2009 (SI 2009/356).

- “(1) A bank liquidator has two objectives.
- (2) Objective 1 is to work with the FSCS so as to ensure that as soon as is reasonably practicable each eligible depositor—
 - (a) has the relevant account transferred to another financial institution, or
 - (b) receives payment from (or on behalf of) the FSCS.
- (3) Objective 2 is to wind up the affairs of the bank so as to achieve the best result for the bank’s creditors as a whole.”

Importantly, under s.103 of the Banking Act 2009 a bank liquidator “may do anything necessary or expedient for the pursuit of” the s.99 objectives.⁹⁶ Under s.99 of the Banking Act 2009, the objectives of the bank liquidator are to work effectively with the Financial Services Compensation Scheme (“FSCS”, which was discussed in Ch.9) and “to wind up the affairs of the bank so as to achieve the best result for the bank’s creditors as a whole”.⁹⁷ To achieve the liquidation there are two phases. In the first phase, a “liquidation committee” is to be appointed once the insolvency order has been made⁹⁸ and that liquidation committee must consist of three individuals appointed by the Bank of England, the FSA, and the FSCS.⁹⁹ The liquidation committee is required by s.102 of the Banking Act 2009 to recommend that the bank liquidator pursue Objective 1 (in s.99) or Objective 2 (in s.100), in particular bearing in mind the desirability of working effectively with the FSCS. The liquidation committee is therefore focused in the first instance on paying back the depositors, or passing a “full payment resolution” in the jargon.¹⁰⁰ Once that is done, a second form of liquidation committee is appointed by a meeting of the bank’s creditors.¹⁰¹

Insolvency and investment banks

- 13–52 There is a further power in s.233 of the Banking Act 2009 for the Treasury to modify insolvency law as it relates to “investment banks” by means of Treasury regulation. The reference to “investment banks” is a reference to banks which safeguard or administer investments, or which deal in investments either as principal or agent.¹⁰² Those regulations may establish a new procedure for investment banks where (i) they are unable, or are likely to become unable, to pay their debts ..., or (ii) their winding up would be fair”.¹⁰³ Those Treasury regulations are required to observe the following principles:¹⁰⁴

- “(a) identifying, protecting, and facilitating the return of, client assets,
- (b) protecting creditors rights,
- (c) ensuring certainty for investment banks, creditors, clients, liquidators and administrators,
- (d) minimising the disruption of business and markets, and

⁹⁶ Banking Act 2009 s.103(1).

⁹⁷ Banking Act 2009 s.99.

⁹⁸ Banking Act 2009 s.100.

⁹⁹ Banking Act 2009, s.100(2).

¹⁰⁰ Banking Act 2009 s.100.

¹⁰¹ Banking Act 2009 s.100.

¹⁰² Banking Act 2009 s.232. See now Investment Bank Special Administration Regulations 2011 (SI 2011/245) which came into effect on April 5, 2011 in relation specifically to investment banks.

¹⁰³ Banking Act 2009 s.233(1).

¹⁰⁴ Banking Act 2009 s.233(3).

- (e) maximising the efficiency and effectiveness of the financial services industry in the United Kingdom.”

Otherwise, there is great lassitude in the nature of those obligations, their detail and the procedures which they require, including whether or not an insolvency order is made by a court or by another class of person.¹⁰⁵

Bank administration: The fundamentals of bank administration

The previous section considered the liquidation of banks. There may well be a part or parts of the bank, however, which continue to do business and which continue to have customers: this rump of a bank is known as “the residual bank”. Part 3 of the Banking Act 2009 provides for the way in which the residual bank’s affairs are to be administered. Administration in this sense pre-supposes that these parts of the business will continue in effect as long as possible, or hopefully with a view to them being returned to “normal” (as that term is defined in the Act and discussed below). Administration of a bank is conducted in detail in accordance with Bank Administration (England and Wales) Rules 2009,¹⁰⁶ although the core legislative principles are set out in Pt 3 of the Banking Act 2009.

An overview of Pt 3 is presented in s.136 of the Banking Act 2009, to the effect that:

- “(2) The main features of bank administration are that—
 - (a) it is used where part of the business of a bank is sold to a commercial purchaser in accordance with section 11 or transferred to a bridge bank in accordance with section 12 (and it can also be used in certain cases of multiple transfers under Part 1),
 - (b) the court appoints a bank administrator on the application of the Bank of England,
 - (c) the bank administrator is able and required to ensure that the non-sold or non-transferred part of the bank (“the residual bank”) provides services or facilities required to enable the commercial purchaser (“the private sector purchaser”) or the transferee (“the bridge bank”) to operate effectively, and
 - (d) in other respects the process is the same as for normal administration under the Insolvency Act 1986, subject to specified modifications.”

The administration process is to be used when a private sector purchaser or a bridge bank has acquired the failing bank under ss.10 and 11 of the Act. The Bank of England must seek an administrator for the residual bank so that the residual bank can continue in operation in the way that administrations are organised under the Insolvency Act 1986 scheme.

The process for obtaining a bank administration order is that the Bank of England may apply to the court, nominating an identified person as the bank administrator.¹⁰⁷ The grounds for making a bank administration order on the application of the Bank of England are that the Bank of England intends to make a property transfer instrument or will apply for a property transfer order,¹⁰⁸ and

¹⁰⁵ See Banking Act 2009 ss.234 and 235.

¹⁰⁶ Bank Administration (England and Wales) Rules 2009 (SI 2009/357).

¹⁰⁷ Banking Act 2009 s.142.

¹⁰⁸ Banking Act 2009 s.143(1)–(2).