# THE MIS-SELLING OF SWAPS:

# FACTS AND LAW IN IMPERFECT HARMONY

At the end of August 2011, Sky News reported that an undercover investigation by its journalists had discovered evidence that high street banks had deliberately and consistently mis-sold derivative products to unsophisticated investors, leaving them with crippling debts when interest rates fell as a result of the financial crisis. Sky's reporter claimed that such behaviour by the banks was likely to lead to a wave of litigation as investors sought to argue that the banks had simply not provided them with sufficient information and advice about the products that they had bought.

An increasing number of claimants, casualties of the financial crisis from 2007 onwards, are seeking to bring claims against banks and financial institutions. They claim they were advised to enter into complicated derivative transactions that they did not understand and which, they claim, were assertively sold as an integral component and a pre-condition of a loan transaction. Heavily incentivised Treasury Departments of major banks sold extraordinarily complex products under the guise of prudent hedging of adverse interest rate movements with little or no explanation as to the catastrophic consequences to the individuals or companies concerned if interest rates went down, not up. These products were structured as one-way bets for the banks concerned, invariably reserving a cancellation option exclusively for the bank to call in the swap at no cost to it (even if it was 'in the money') but at a colossal and sometimes terminal cost to the client if the swap was 'out of the money'.

Unfortunately, despite these facts, many of these claims are destined to fail as a result of the English court's newly-minted doctrine of 'contractual estoppel', leaving many companies and individuals with huge losses for which they have no remedy. Arguably, the approach that English courts are taking is somewhat divorced from the realities of the business world, which is having unintended but dire consequences for businesses and individuals across the UK and beyond. Alarming numbers of businesses and individuals are confronting potential insolvency, given the huge liabilities they now face as a result of entering into complex derivatives transactions. Many parties only entered into these transactions because of the way their banks sold these products to them. This often led to a critical misunderstanding about the potential exposure to risk, which the financial crisis has devastatingly revealed.

Our experience at Enyo Law is that more and more clients are seeking to recover their losses by bringing claims against the financial institutions which sold them products without making them fully aware of the risks involved. However, there is one significant legal stumbling-block for these clients – contractual estoppel. Put simply, if you have agreed in contractual documentation with the bank or institution that the information they have given you (about the product you are buying) does not constitute 'advice' and /or that you have not relied on any communications from the bank or institution as to whether the product is appropriate and /or that you fully understand the terms, conditions, and risks of the purchase, even if each of these points are factually incorrect and untrue, then the bank or institution cannot be liable for the consequences of your purchase.

## Contractual estoppel

This approach is a fairly new one. Up until 2006, whilst English judges would always consider the written contract, they were generally prepared to recognise that what was set down in writing did not always reflect the realities of the relevant transaction. For example, back in 1960, the Court of Appeal was prepared to recognise that parties could not agree to enter into a contract on the basis of something that they both knew to be untrue in reality[1]. In other words, a bank could not claim that it was not giving advice, if both parties knew and accepted in reality that that was exactly what it was doing.

The turning-point came in 2006 with a case called *Peekay*[2]. In this case, the Court of Appeal decided that, in spite of its earlier decisions, where parties had agreed to enter into a contract on a certain basis, they could *not*

[1] *Lowe v Lombank* [1960] 1 WLR 196

[2] *Peekay Intermark Ltd v Australia and New Zealand Banking Group Ltd* [2006] 2 Lloyd's Rep 511

then claim at a later stage that the reality of the situation was something different. Thus, if an investor who had purchased a certain product signed contractual documentation that stated that he had not been advised by the bank about that product, then that is what the court would find. Furthermore, and as a result of this, the bank could not be found to have been negligent or to have misrepresented the position, since no advice had been given in the first place.

This doctrine of contractual estoppel was given further credence last year when the Court of Appeal considered the case of *Springwell*[3]. Springwell, a Greek shipping company, sought to recover over US$700 million in damages arising from its investment in Russian sovereign debt in the 1990s. The Court of Appeal rejected its claim that the Chase Manhattan Bank (now JP Morgan Chase) had mis-sold these investments to Springwell. Springwell had claimed that JP Morgan Chase owed it advisory duties, but the court was clear that the bank had no duty to advise the company. In the relevant contractual documentation, Springwell had agreed that the bank was not making any representations (i.e. the bank was not advising Springwell). Therefore the company was 'estopped', and prevented from bringing a claim based on any alleged misrepresentation or negligent misstatement by the bank. No representations were made, so no misstatement or misrepresentation could be found. The court also rejected the claim that the relevant contractual clauses were unreasonable and thus void under section 3 of the Misrepresentation Act 1967.

Following *Springwell*, the courts have generally adopted what is being perceived as a pro-bank approach to date[4]. In case after case, where an investor has signed a contract containing standard disclaimers and acknowledgements that a particular state of affairs is the basis of that contract, regardless of whether or not that state of affairs does indeed reflect reality, those clauses have been found to prevail. Such clauses include the standard entire agreement and non-reliance clauses that are prevalent in all of the usual documentation relating to derivative products (e.g. the ISDA Master Agreement). The 'freedom of contract' rationale for this was explained by Mr Justice Christopher Clarke in *Raiffeisen Zentralbank Osterreich AG v RBS plc*[5]:

> "*It is obviously advantageous that commercial parties of equal bargaining power should be able to agree what responsibility they are taking (or not taking) towards each other... If sophisticated commercial parties agree, in terms of which they are both aware, to regulate their future relationship by prescribing the basis on which they will be dealing with each other and what representations they are or are not making, a suitably drafted clause may properly be regarded as establishing that no representations (or none other than honest belief) are being made or are intended to be relied on.*"

This makes the courts' attitude clear. Whatever the reality of the situation, the strict wording of the original contract is upheld.

**The problem with contractual estoppel**

The courts' pro-bank conclusions, whilst intended to ensure that sophisticated commercial players have legal certainty in their transactions, appears to be having a more significant and unanticipated impact. Whilst retail customers have the benefit of wider protection under the financial services regulatory regime, small and medium-sized businesses do not - and yet they are often more akin to retail customers than to larger sophisticated businesses with experience in complex investment products (such as Springwell).

Nonetheless, the courts' line of reasoning binds all businesses because it focuses on and elevates the standard form wording in banking documentation above all the more subtle considerations and realities of the particular transaction and the bank-customer relationship which preceded the completion of the documentation. This is a

[3] *Springwell Navigation Corporation v JP Morgan Chase Bank & Ors* [2010] EWCA Civ 1221

[4] For example: *Titan Steel Wheels Limited v Royal Bank of Scotland plc* [2010] EWHC 211 (Comm); *Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland plc* [2010] EWHC 1392 (Comm); *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm); *Bank Leumi (UK) plc v Wachner* [2011] EWHC 656 (Comm); *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm).

[5] [2010] EWHC 1392 (Comm)

very blunt approach and one which, in our view, is far removed from what international and local businesses should be able to expect from an English court.

**An international perspective**

The approach taken by the English courts differs drastically from that taken by courts in other jurisdictions, where the banks have been proving less successful in defending litigation involving complex financial instruments. In March 2011 the German Federal Court of Justice gave its first ruling in relation to a case involving interest rate swaps[6]: it found that Deutsche Bank had sold swap products without providing its customer, Ille Papier Service, with enough information about the related risks. Given the involvement of so many German banks in the swaps market, this decision was expected to have far-reaching consequences for the German banking industry. In early September 2011 the Ontario Superior Court of Justice ruled that Barclays Bank had made fraudulent misrepresentations during its negotiations with Devonshire Trust, failing to tell the Trust about the nature of relevant negotiations in early 2009 in order to avoid the risk of it terminating two swap transactions[7].

Given the pro-bank results in England, some banks even appear to be engaging in tactical forum-shopping in order to try to ensure a more favourable result. In Italy, where a large number of public bodies were exposed to losses originating from investments in derivatives, claim after claim has been brought against the banks. However, given that most derivatives contracts are governed by English law, and are therefore subject to the jurisdiction of the English courts, the litigation has been dominated by skirmishes over jurisdiction as the banks have sought to transfer the disputes to England, where they hope to achieve a pro-bank solution[8]. Increasingly, it appears that the English courts have developed an international reputation for supporting the banks in complex derivatives disputes, much to the irritation of many foreign companies and their lawyers. Whilst the banks are actively seeking to ensure that such litigation goes ahead in England, their opponents are certainly doing their best to avoid it.

**Combating contractual estoppel**

With the English courts placing so much reliance on the contractual estoppel principle, is there anything that can be done to undermine the banks' arguments and their all-encompassing terms and conditions?

*(i) Sophistication*

One of the arguments that has been raised against the contractual estoppel approach is implicit in the quotation from Christopher Clarke J above. What about the unsophisticated investor? Is equality of bargaining power always to be assumed? Is a party with little or no experience in dealing with complex derivatives products simply to be assumed to have made its own decisions, independently of the bank, based on the standard terms inserted into the relevant contracts? This seems manifestly unfair.

Unsurprisingly, in a number of recent cases, parties have tried to argue that they lacked the sophistication and expertise required to make informed decisions about the relevant products (which, in turn, suggests that the financial institutions with which they were dealing had assumed an advisory duty of care). For example, in *Titan Steel Wheels*[9] the claimant was a manufacturer of wheels and argued that it was not carrying on business as a professional investor. Similarly, in *Cassa di Risparmio*[10] the claimant said that it "*did not have sophisticated knowledge of structured credit*", whilst the defendant bank was a "*major participant*" in the relevant market. These arguments have not found much favour with the courts, which have taken the approach that the parties concerned were sophisticated enough to understand what they were buying. However, it remains to be seen how the courts will treat a less sophisticated claimant – whatever the nature of the contractual clauses about non-reliance.

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[6] *Ille Papier Service GmbH v Deutsche Bank AG* XI ZR 33/10

[7] *Barclays Bank v Metcalfe & Mansfield,* 2011 ONSC 5008

[8] One example of the successful transfer of proceedings from Italy to England is *Depfa Bank plc v Provincia di Pisa; Dexia Crediop SpA v Provincia di Pisa* [2010] EWHC 1148 (Comm)

[9] *Titan Steel Wheels Limited v Royal Bank of Scotland plc* [2010] EWHC 211 (Comm)

[10] *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm)

*(ii) Finding a representation and construing the contractual wording*

The case law shows that, even where there are standard entire agreement and non-reliance clauses, the courts are prepared to carry out an exhaustive analysis of the relevant evidence to see if representations were indeed made and whether they did in fact fall within the ambit of the contractual wording set out in the banking documentation. At first instance, in the *Springwell* case itself, Mrs Justice Gloster scrutinised the various sales discussions to try to locate any instance of a statement that might amount to a misstatement or misrepresentation. In *Standard Chartered Bank v Ceylon*[11] and in the *Cassa di Risparmio*[12] case, Mr Justice Hamblen carefully considered what was said by whom to whom and the scope of the relevant contractual clauses which the banks were relying on. In each of these cases, the judge found that there is a clear distinction between giving advice and assuming legal responsibility for that advice. He also considered whether the contractual clauses covered the advice given. Whilst no advisory duty was found in these cases, and the contractual wording was held to be sufficiently wide to cover the alleged representations, it is entirely possible that, had an example of a clear representation been identified which was not specifically covered by the contractual wording, the outcome of that case may have been quite different. As Christopher Clarke J said in *Raiffeisen Zentralbank*: "*Everything must depend on the facts*".[13]

*(iii) (E)stopping estoppel?*

A further, rather ingenious approach to contractual estoppel was taken by Ceylon Petroleum Corporation (CPC) in the Standard Chartered Bank case[14]. CPC accepted that the court was bound by the decision in *Springwell* – that non-reliance provisions in the relevant contracts created a contractual estoppel in the bank's favour – but it reserved the right to argue in a higher court that *Springwell* was wrongly decided.

CPC argued that the non-reliance provisions were not binding on CPC because the bank was *itself* estopped from relying on them. In summary, CPC said that, because both parties had assumed that the bank was advising CPC and that the bank could and would be liable for that advice, the bank could not now claim to rely on the non-reliance provisions in the relevant contracts.

Hamblen J ultimately ruled, on the basis of the facts, that the bank had not made this assumption, and so CPC's argument failed. He also noted that one "*cannot, merely by referring to what is asserted to be the underlying reality, avoid the effect of* [the contractual] *provisions*." Nevertheless, the judge did find, in examining the evidence regarding CPC's flawed understanding in relation to the valuation and unwinding of the transactions in question, that "*CPC was to an extent let down*" by the bank. As he had found no general advisory duty, this factual finding had no legal consequences. It does however indicate the closeness with which the court is prepared to scrutinise a bank's actions in seeking to identify a possible breach.

**An academic approach**

At least one academic has argued that the application of contractual estoppel by the courts has implications far beyond the world of sophisticated investors and is pushing the idea of contractual and commercial certainty to potentially unjust extremes. Gerard McMeel[15] has argued that the juridical basis for the choice and implementation of a doctrine of contractual estoppel is actually remarkably weak[16]. Estoppel, as a doctrine, has traditionally required proof of reliance and an element of unconscionability – both of which are lacking from the court's current interpretation of "*estoppel by contract*". Furthermore, given the earlier decisions of the Court of Appeal (prior to *Peekay* in 2006)[17], Professor McMeel has suggested that *Peekay* and *Springwell* were actually incorrectly decided. However, a ruling of the Supreme Court would be required to overturn those decisions.

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[11] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm)
[12] *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm)
[13] [2010] EWHC 1392 (Comm)
[14] [2011] EWHC 1785 (Comm)
[15] Professor of Law, University of Bristol; Barrister, Guildhall Chambers, Bristol, and Quadrant Chambers, London
[16] Gerard McMeel, *Documentary fundamentalism in the Senior Courts: the myth of contractual estoppel* [2011] L.M.C.L.Q. 185
[17] Such as *Lowe v Lombank* [1960] 1 WLR 196

Perhaps now is the time for a suitable case to progress to that court in order for the final word on contractual estoppel and its potentially unjust consequences.

**A way forward**

Given the recent string of pro-bank outcomes, it is understandable that potential claimants might be put off attempting to bring a claim. However, it is entirely possible that a case founded on the right factual matrix could seek to stem, if not turn, the tide. The Unfair Contract terms Act 1977, S. 150 of the Financial Services and Markets Act 2000, the FSA Conduct of Business Rules (pre 1 November 2007) and the Conduct of Business Sourcebook Rules (post 1 November 2007) must also be put into the mix. The FSA Rules are of particular interest given that the banks are unable to exclude the obligations that they owe to the customer under those Rules[18].

A claimant with little or no real experience of the complex financial instruments in question, who can adduce clear evidence that representations were made about the suitability of investing in such products, may stand a chance of defeating the presumed estoppel which currently flows from the standard non-reliance clauses. If that claimant has factual evidence that both it and the defendant financial institution assumed those representations to be advice, for which the institution was liable, so much the better! It is certainly time that the English courts reconsidered a doctrine that is leaving so many victims of 'hedging products' in a perilous financial position, whereas the banks who sold, and arguably mis-sold, those products continue to seek shelter behind their terms and conditions.

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[18] See COB 2.5.3R and COBS 2.1.2R