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Banking and finance disputes review

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From the editor

The *Banking and finance disputes review* has always aimed to predict the trends of the future as well as commenting on the latest court decisions and legal developments. In this edition, *New trends in banking litigation* uses our award-winning Court Intelligence Database to give insights into how banking litigation is conducted in the English courts and – as the title suggests – what new trends are emerging.

One of the key findings of our analysis is that fraud is moving with sudden speed to become a key argument in a significant proportion of major banking disputes. Two articles deal with fraud and related claims. In *Civil claims against banks arising from bribery and corruption issues*, we look at fraud from the perspective of a financial regulatory investigation. In *Letters of credit – the fraud exception*, we see the English courts take a characteristically robust and commercial approach to fraud in a particular area of international finance.

Our analysis also gives comprehensive data on the duration and outcome of English banking litigation. With the approach of Brexit, the advantages – or otherwise – of litigating in England is in the spotlight and banks are monitoring alternative methods of dispute resolution. In *Financial institutions: addressing misconceptions about arbitration*, we give an introduction to arbitration for banks and, in *Investor state dispute settlement in the banking and finance sector*, we look at one niche – but increasingly important – area where arbitration is already used by banks.

Finally, the Court Intelligence Database shows that mis-selling claims, although starting to decline in number, still dominate banking litigation. Three articles dealing with recent cases arise out of mis-selling scenarios: our casenote on *CGL Group Ltd v Royal Bank of Scotland plc* [2017] EWCA Civ 1073 and our articles *Thomas v Triodos: revisiting the duties of care owed by banks* and *Challenging governing law clauses: re-match in the Court of Appeal*. Another source of banking disputes that has become topical recently is dealt with in *Restricting permissible loan transferees: “Financial institutions” and Argo Fund revisited*.



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New trends in banking litigation

The Commercial Court and Chancery Division of the High Court in London have hosted large-scale financial litigation for many years. New cases in these Courts may presage important international trends in regulation or liability and the outcomes of conflict can inform risk allocation in the financial sector.

In this article, we examine trends in recent and ongoing financial litigation in these Courts, give specific guidance on how likely different types of dispute are to settle and identify the surprisingly sudden emergence of a new source of liability for banks based on fraud. The information in this article comes from Norton Rose Fulbright’s award-winning Court Intelligence Database (“CID”, see Box).

What happens to banking cases?

Systematic monitoring of cases traditionally focuses on judgments: the outcomes of cases that are fought all the way to a decisive result. But this gives no information on the first and most vital questions for any litigant: whether the case will go to trial and how long it will take.

CID monitors ongoing litigation and so can answer these questions. Interestingly, the most important factor is whether the case is principally about mis-selling. Mis-selling cases are more likely to be settled before going to trial.

How many cases settle?

Overall, just under 25 per cent of CID cases proceed to trial and judgment.

This is actually fairly high compared to litigation generally. CID cases may represent larger disputes where there has been extensive discussion prior to the commencement of legal proceedings, so that those that end in litigation are relatively intractable. Clearly, whether a dispute is settled depends on the particular circumstances of that claim. Nevertheless, the starting point for risk evaluation and management by a bank receiving a claim form is that just over three-quarters of claims will not reach final judgment.

For a mis-selling case, the chance of settlement is higher. Only about 15 per cent of mis-selling claims are taken all the way to judgment. For non-mis-selling claims, the ratio is proportionately higher: about one-third of all non-mis-selling claims go to trial. The claimants in mis-selling claims tend to be less sophisticated and the amounts at stake smaller. Conversely, many non-mis-selling claims are large disputes where the issuance of a claim form follows extensive negotiation, so that a higher proportion of non-mis-selling claims may settle before a claim form is issued.

Figure 2 and Figure 3 show the final stage that mis-selling and non-mis-selling claims reach. Apart from the overall rate of settlement, these two Figures also reveal further patterns. Mis-selling claims appear to have a fairly constant probability of settling over time – claims are dealt with at a steady rate resulting in fewer surviving to the later stages. Non-mis-selling claims do not exhibit a constant probability of settling. Instead, they appear to be marked by specific milestones which may precipitate settlement. In particular, they tend to settle soon after issuance or close to trial – perhaps marked by exchange of expert witness evidence or disclosure.

Figure 2: Final stage reached by non-mis-selling claims in the High Court

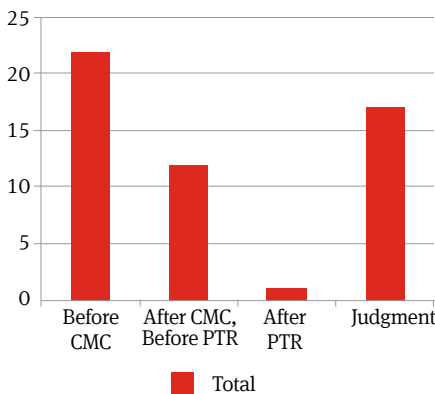
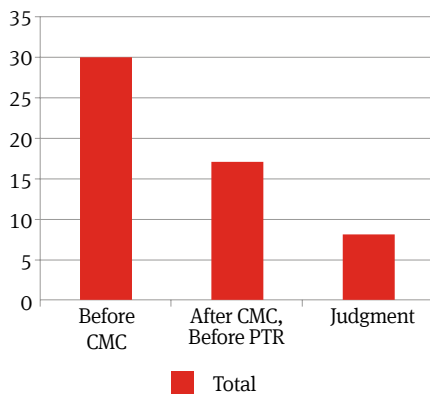


Figure 3: Final stage reached by mis-selling claims in the High Court



This pattern accords with a litigator’s intuition as to the progress of large cases. Issuance of a claim may concentrate the parties’ attention and lead to settlement. If it does not, then expert evidence and disclosure generally mark a further step change in the level of knowledge of the parties. If the case does not settle quickly, then the parties may decide to undertake disclosure and obtain expert evidence so that they will have a clearer idea as to the strength of the case. This precipitates a further wave of settlement later in the life of the litigation.

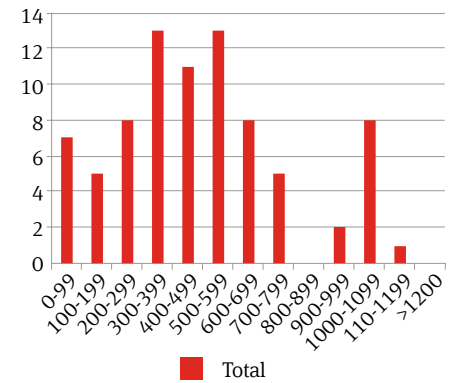
The pattern in Figure 3 is likely to emerge when legal costs are small in relation to the size of the claim: there is less opportunity cost in obtaining expert evidence, for instance, to evaluate more precisely the strength of the case. Where legal costs are higher in proportion to the size of the claim, they are a constant drain and so there is a continuing incentive to settle, leading to the pattern of Figure 2. Alternative fee arrangements may also be a greater factor in these claims.

Intuition may be useful; sometimes it may mislead. The importance of the conclusions set out here is that they are based on objective data. Figures 2 and 3 show real differences in the course of litigation. Banks and financial institutions should take account of this when planning the size and distribution of their legal spending and their approach to determining claims.

How long does litigation last?

This is yet another basic question for litigants where traditionally the answer has been supplied by intuition without any attempt at verification or is limited only to the experience of one law firm. Using CID, Figure 4 shows the overall duration of major financial litigation in the High Court, from cases that settle immediately after issuance of proceedings through to those that are taken to final judgment.

Figure 4: Duration (in days) of major financial litigation in the High Court



We can also separate out the duration of cases by their outcome: cases that go all the way to judgment last longer than those that settle. The overall average for litigation is just over 500 days – a little less than a year and a half. The average for cases that go all the way to judgment is just under 700 days – nearly two years.

Again, this is crucial information for litigants, especially when taking into account the data on the likelihood of settlement. This data is inevitably backward-looking to some degree: we only know how long a case lasts once it has finished. Nevertheless, it is based on cases currently settling or otherwise being determined and so is as up-to-date as possible.

We have excluded from this calculation cases that end without any clear marker: those that are simply allowed to fade away when no further action is taken but without any notice on the court record that fixes the date of settlement or discontinuance. This is because the precise date the case ends is not known. Including these cases would push the overall average for litigation up to nearly 600 days. This probably corresponds to the delay in knowing that a case in this category has actually ended, so that it does not affect the conclusions set out here.

How many cases are there?

The English courts have traditionally played their part in the role of London as a global financial centre, providing a home for large-scale international disputes. Following the vote for Brexit, there has been increased speculation as to whether the scale and volume of litigation in the English courts would be affected, particularly in relation to banking and financial services.

Of course, Brexit can only be one factor in the overall volume of litigation. Fallout from the financial crisis, the state of the economy and the impact of regulation will all impact the scale and nature of important banking and finance cases litigated in the English courts. Nevertheless, this is still an important benchmark for the financial services industry in the UK.

In fact, over the last few years, the number of important banking and finance cases has remained relatively stable, within a range of approximately 80 to 100 cases. Given the average duration of eighteen months set out above, it follows that about 50 to 60 cases per year are resolved and are replaced by new cases.

Two points follow from the broadly static general trend. Firstly, the end of financial crisis-related disputes has had surprisingly little effect on the volume of these cases. Cases stemming from the events of 2007 – 2009 and subject to the standard six year limitation period would cause a bulge in litigation ending in around 2017. But other sources of litigation appear to have filled the gap – we consider the breakdown of cases by category further below.

Secondly, there has not yet been any significant effect from Brexit. The total number of cases arguably shows a gentle decline within the overall range – continued monitoring will be able to show whether this decline becomes established. It may be that Brexit effects are yet to be felt. The European system for judicial co-operation and enforcement is still in place and will not change before 2019 – any effect would be purely a result of psychology rather than substance. Efforts by the UK Government to propose continued judicial co-operation and by English lawyers to explain that Brexit will have minimal consequences for the conduct of English litigation appear to have been effective so far.

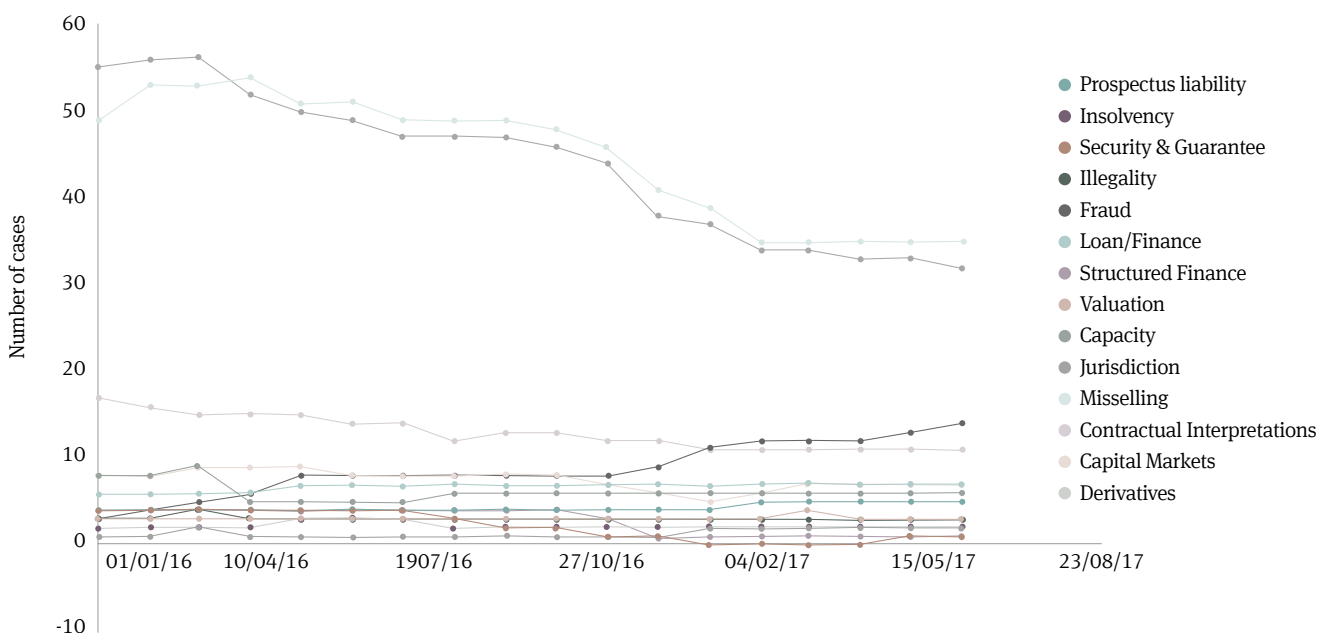
What trends are there for future cases?

New arguments appear for the first time in pleadings. If a financial institution only consults judgments in decided cases, it will not see over three-quarters of these arguments at all and the remainder only after about two years. By then, any litigation trend would be well-established. Accordingly, it is vital for risk management and strategic planning to be able to spot new arguments at the pleading stage.

Using CID, Figure 1 sets out how many cases fall within a number of different categories, looking at major financial litigation in the High Court. Two trends appear. Firstly, there has been a marked decline in litigation relating to mis-selling and derivatives (and these two categories largely overlap).

This is undoubtedly due to time elapsed since the financial crisis. Abrupt dislocations in interest rates and other financial metrics during 2007 – 2009 led to litigation which, taking into account the six year limitation period and two year average case duration, is now winding down. This is a gradual process and

Figure 1: Major financial litigation in the High Court: number of cases in each category



new sources of mis-selling claims continue to arise, also generally related to market dislocations since the financial crisis. Nevertheless, it appears that the peak in derivatives mis-selling cases has passed – at least those based on interest rate hedging products sold to SMEs.

As set out above, the overall volume of cases has not seen a marked decline – so what is replacing derivatives mis-selling claims? All other categories of claim show little change, apart from one: fraud. There has been a steep increase in claims that involve allegations of fraud. A few years ago, there were typically two or three such cases involving banks being litigated at any one time. By the middle of 2017, there were 14 cases involving fraud. The lesson for banks and financial institutions is clear: they should be prepared to manage a greater number of fraud cases and they should understand the risk factors that lead to disputes involving fraud.

Why are there more cases alleging fraud?

The factual matrix underlying each particular dispute determines whether allegations of fraud are made and whether they are successful. However, it is possible to extract from recent and current cases various factors that might motivate allegations of fraud:

Circumventing basis clauses

“Basis clauses” are statements in a contract that set out the basis on which the parties are dealing, eg, a statement that a counterparty is a sophisticated investor. Courts have strictly enforced basis clauses, even where they effectively constitute exclusions of liability. They are not subject to the reasonableness limitations that apply to exclusion clauses as set out in the Unfair Contract Terms Act 1977 (UCTA). In fact, there have even been examples where the Court has held that

a basis clause successfully precluded liability even where that clause would have been deemed unreasonable if UCTA had applied – see our previous articles on basis clauses, [Contractual estoppel in mis-selling claims](#) and [Contractual estoppel and the duty to advise: Where are we now?](#).

An allegation of fraud is one way to revive a claim that is otherwise precluded by a basis clause. A party cannot rely on a basis clause to negate liability based on fraud. Accordingly, strict enforcement of basis clauses by the Courts over the last few years has created pressure which may have been relieved by increased pleading of fraud.

This suggests that fraud allegations arise where there has been a breakdown in the relationship between an investor and a financial institution and where the relationship between them was mediated by a contract that included a basis clause. This would include mis-selling claims as well as claims more widely involving bank-client relationships.

Obtaining new remedies

English courts have traditionally provided a wide range of remedies for fraud. In recent years, this has been further enhanced by their zeal to combat money laundering, bribery and corruption. Worldwide freezing orders, constructive trusts, equitable tracing and equitable receivership all form part of the flexible and effective tools available particularly in cases of fraud.

But the key remedial advantage when pleading fraud is the availability of rescission: the right to cancel the contract and put the parties in the position they were in before the contract was entered into. Where one party is seeking to extricate itself from a bad bargain, this is a tempting prospect.

Claims to rescind interest rate derivatives based on manipulation of LIBOR are an example. Interest rates moved unexpectedly following the financial crisis, leaving a number of businesses with hedging arrangements that were expensive and worthless. Basing a claim that would otherwise be simple mis-selling on fraudulent misrepresentation allows a party to cancel an unprofitable contract where no damages would be recoverable.

This suggests that fraud claims arise when banks or their counterparties are trapped in bad contracts, perhaps following abrupt market dislocations. For instance, they could be consumers alleging interest rate hedging products were mis-sold, or they could be securitisation issuers seeking to unwind one leg of back-to-back currency hedging arrangements. In all these cases, rescission is a powerful remedy, if fraud can be established.

Increased regulatory oversight

Since the financial crisis, banks have seen increased regulation and regulators have pursued wrongdoing with greater zeal. There have been several wide-ranging reviews of behaviour during and since the financial crisis, putting into the public domain voluminous detail relating to bank activity regarding LIBOR and other indices, interest rate hedges and many other products. Claimants may attempt to piggy-back on regulatory findings where they are investors in products that have been investigated by regulators or that refer directly or indirectly to indices that have been investigated by regulators. These claims are generally phrased in terms of fraud allegations.

Longer limitation periods

Claims involving fraud may be able to take advantage of longer limitation periods – in particular, where the claimant is not aware of the facts

underlying the fraud until after the transaction is entered into. Given that the financial crisis occurred in 2008 – 2009 and that the standard limitation period is six years, many disputes are now in the critical stage immediately following expiry of the limitation period, when all claims other than based on fraud are barred.

This suggests that some of the fraud allegations may be motivated by an attempt to circumvent limitation periods and that this will naturally decline as we move beyond the critical period for most claims.

Will the trend continue?

Our analysis is inherently forward-looking because we are examining current and ongoing litigation rather than decisions from completed cases. So the trends we identify here will start to be reflected in judgments in the next few years. In short, more judgments dealing with fraud will be a feature of English jurisprudence irrespective of whether the trend identified by CID continues.

Nevertheless, it is interesting to speculate as to whether new disputes will continue to allege fraud and whether the total volume of disputes before English courts will remain steady. Most of the drivers for fraud allegations listed above are still active. The political and business environment appears to have permanently embedded an increased focus on regulation and wrongdoing, so regulatory oversight and enhanced fraud remedies will continue to underpin fraud claims. Until the expansive view of basis

clauses is changed – and many academic commentators think it should be changed – then this factor will also persist. The only factor with waning influence is the extended limitation periods available for some fraud claims. Overall, then, fraud is likely to continue growing in importance. There may even be a positive feedback effect: when judgments featuring fraud arguments increase in frequency, this could inspire new claimants to include fraud arguments. In this way, a new higher level of fraud claims may become a visible feature of the litigation system.

Conclusions

The Court Intelligence Database analysis of current litigation gives valuable insight to financial participants in English litigation. Definitive, objective data is available on what kinds of cases settle, how long litigation takes and what sort of arguments feature in current cases.

English litigation has proven itself resilient to the gradual decline of financial crisis disputes, partly due to the new trend of increasing fraud claims. The great imponderable, of course, is how Brexit will affect the level and nature of litigation in the English courts. This will be addressed in further updates from the Court Intelligence Database in coming editions of the BFDR.

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Norton Rose Fulbright's Court Intelligence Database

The Norton Rose Fulbright Court Intelligence Database (CID) is a “big data” cloud-based database which monitors all live cases involving banks and financial institutions in the English courts. This is in addition to the small proportion that end in decided judgments after several years. The claims can be broken down by subject matter, law firm, barrister, the stage of the claim, the identity of the parties involved, and their status in the litigation. CID not only assists in spotting litigation trends but it also checks and tracks the types of arguments employed by parties and counsel, the progress of a case, and where parties are taking inconsistent positions in different disputes.

The Court Intelligence Database won the “Knowledge Management Innovation” award at the 2016 *Legal Week* Innovation Awards and was also shortlisted in the “Innovation in Business Development and Knowledge Sharing” category at the *FT* Innovative Lawyer Europe Awards 2016.

Civil claims against banks arising from bribery and corruption issues

Bribery and corruption allegations have been central to some high-profile regulatory investigations of banks. While most major banks have sophisticated systems and controls to manage corruption and money laundering risks, there is a growing need to include in investigations the risk of civil claims as well as criminal or regulatory action. Civil claims relating to bribery and corruption are well-established in the US, and have become increasingly common in other jurisdictions, particularly the UK. There have been numerous claims arising out of allegations of mis-selling of derivatives and several recent significant claims in the English courts have involved allegations of bribery against banks.

In this article, we address the key civil liability risks for banks that may emerge in the course of an investigation into bribery or corruption. If a transaction was procured by bribery, it may be unwound, leading to remedies that in some circumstances are more prejudicial to a bank than damages for breach of contract. If the transaction is tainted by corruption, this may jeopardise the bank's investment and lead to liability for claims including unlawful means conspiracy and dishonest assistance.

Transactions procured by bribery

Under English law, a contract procured by bribery is voidable and may be set aside (i.e. unwound) at the election of

the innocent party. Bribery can include the giving of various advantages by bank employees or other agents, including money, gifts, entertainment, or jobs. Importantly, the party seeking to unwind a contract does not have to prove a criminal offence has been committed. The civil concept of bribery is based on the concept of a secret commission or other secret benefit being paid to an agent or employee of the principal by a person aware of the nature of the relationship between the agent/employee and the principal (*Petrotrade Inc v Smith* [2000] 1 Lloyd's Rep 486). It is not necessary to show that the paying party paid the secret commission to obtain a benefit or otherwise to induce the agent/employee to enter into a contract on behalf of the principal. Consequently, if the bank's agent has bribed an

employee or official at the counterparty, it is possible that the entire deal might later be liable to be set aside.

Recent examples of bribery

In 2014, the Libyan Investment Authority (LIA) brought a civil bribery claim against a French bank in relation to transactions in the period 2007-9. The LIA sought to unwind those transactions. It alleged that Panamanian-registered company was owned by a Libyan businessman and that a payment of US\$58 million to it by the bank was a bribe. The case was settled before trial.

A related claim by the LIA was based, not on bribery, but on undue influence. On October 14, 2016, the English High Court rejected the LIA's claims that Goldman Sachs had exercised undue influence to procure the LIA to enter into a series of derivatives transactions or that the trades otherwise amounted to an unconscionable bargain (*Libyan Investment Authority v Goldman Sachs* [2016] EWHC 2530 (Ch)). The LIA did not allege bribery in that case but argued that the offering of an internship within Goldman Sachs to the brother of the Deputy Chairman of the LIA improperly influenced the LIA to enter into the trades of US\$1.2 billion.

In December 2016, a Dutch Housing Association, Vestia, issued a claim against a German bank in the English High Court alleging that that the bank

bribed one of its officials to enter into swaps between 2005 and 2011 in the form of hospitality and by virtue of payments to a broker who allegedly made payments to the official.

More recently, the Court of Appeal held that a German water company could rescind a credit protection contract in relation to derivatives entered into with a Swiss bank on the basis of bribes paid by the company's financial adviser, upholding the first instance decision (*UBS v KWL* [2017] EWCA (Civ) 1567). The Court of Appeal rejected the first instance finding that the financial adviser was the bank's agent. The financial adviser had formally been engaged by the company, and the bank had been unaware of the bribes. However, the majority considered that the bank could not enforce the transaction as, even though it was not aware of the bribe, it dishonestly assisted in the financial adviser's breach of its fiduciary duties, in particular the duty to provide loyal and disinterested advice. The company had been entitled to decide whether to continue with the credit protection contract or rescind it (i.e. cancel the contract with the effect that the parties would be put into their respective pre-contractual positions). The company had elected to rescind, which required it to return the US\$30 million premium, but enabled it to avoid paying out US\$137 million under the credit protection contract.

Banks are particularly susceptible to claims to unwind transactions. Rescission is more likely to be available in a financial transaction which simply involves payments of money because there is no obstacle to reversing the transaction to put the parties back in their original positions. And, as the cases above illustrate, rescission is particularly attractive for financial contracts when the breach itself has not caused any damage but, due to

market movements, the contract as a whole is unprofitable.

To mitigate bribery risk, banks need to understand the role of third parties and conduct thorough due diligence on them, irrespective of which party has formally engaged them. Banks also need effective controls in relation to entertaining clients, particularly where those clients are government officials or otherwise have government connections.

Transactions tainted by corruption

The risk of civil claims against banks arising out of bribery and corruption is not confined to transactions procured by bribery. Where the sums advanced by the bank are to be used for corrupt purposes, the bank may be exposed to a number of different claims.

We consider this via a hypothetical example. Suppose a bank enters into a finance transaction with a sovereign government. The purpose of the transaction is to finance an infrastructure project, but the bank has reason to suspect that much of the sum advanced is going to be diverted to corrupt government officials. The immediate risk is that the project may not be completed or might be stopped or unwound and that the bank will not be repaid. However, even if repayment is secured other than by performance of the project, perhaps by a sovereign or third party guarantee, the bank is still exposed to a number of potential civil claims, the most obvious being unlawful means conspiracy.

For a claim of unlawful means conspiracy to succeed, it is necessary to establish the use of unlawful means (i.e. fraud) in furtherance of an agreement, and an intention to cause injury to the borrower. It is not necessary to show a binding contractual agreement as between the

bank and a fraudster: a tacit agreement or understanding or combination is likely to suffice. From an evidential perspective, linking the bank and the fraudsters in government might be difficult, but it is not a risk that banks should discount, especially given the time and cost of a dispute, the associated regulatory scrutiny and reputational risk.

An intention to cause injury can be established where it can reasonably be foreseen that the conspiracy might cause loss to the borrower. If parties are aware that the funds are going to be diverted to corrupt purposes rather than the putative purpose of the transaction, this is likely to be sufficient. Turning a blind eye will constitute knowledge for these purposes. Where there is actual dishonesty by bank employees, the bank may also be liable for dishonest assistance.

Practical implications for investigations

The interplay of civil corruption litigation, regulatory supervision and enforcement, and money laundering reporting obligations presents practical challenges for banks, particularly in relation to privilege issues and tipping off.

Consider the scenario of an allegation of corruption being made in relation to a third party on a derivatives deal. The bank may be required to notify the National Crime Agency of the FCA report and is also likely to want to investigate the allegation itself. In doing so, however, it may create documents which could be used against it in subsequent civil proceedings. Given the recent decision in *The Serious Fraud Office v ENRC* [2017] EWHC 1017 (QB) (ENRC), documents are unlikely to attract litigation privilege unless civil claims are contemplated.

In ENRC, it was held that, in the context of a criminal investigation, litigation privilege would only be triggered once prosecution was reasonably in contemplation: the fact that a criminal investigation was feared or had even commenced was not enough to trigger litigation privilege if, at that stage, the focus of the investigation was to fact find and no prosecution was contemplated by the entity being investigated – see our briefing ([When does “litigation” become sufficient to trigger litigation privilege?](#)) and note that the decision is subject to appeal.

Equally, the bank will need to be careful in its investigations and in any dispute to avoid committing tipping off offences under the Proceeds of Crime Act 2002 when corresponding with the third party. Financial institutions will also need to consider how decisions made in responding to, or settling, regulatory investigations will play out in potential litigation.

Summary

Recent cases show the increasing willingness of parties who feel they have been wronged by corruption – or who have made a bad bargain in a deal potentially tainted by corruption – to pursue civil claims. English law civil corruption litigation is still at an early stage of development but it is beginning to move into the mainstream.

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Letters of Credit – the fraud exception

English law vigorously upholds the principle of autonomy in relation to letter of credit (LoC) and demand guarantee transactions, as demonstrated in a number of recent cases. Only where there is fraud will English courts provide relief from paying out against an otherwise complying presentation or demand. In taking this approach, the English courts seek to avoid interfering with obligations that are considered to be “the lifeblood of international commerce”. However, financial institutions entering into letter of credit transactions should be aware that not all jurisdictions follow the autonomy principle as strictly and should take steps to mitigate the risks of being trapped between different approaches.

What is a LoC?

LoCs are a common method of payment for parties in different jurisdictions engaging in the international trade of goods. A LoC is a written commitment by a bank to make payment to a beneficiary on the satisfactions of certain conditions. The buyer of the goods (the applicant for the credit) requests a bank (the issuing bank), which is usually a bank in the applicant’s jurisdiction, to open a LoC in favour of the seller of those goods (the beneficiary of the credit). Often, the issuing bank also arranges with another bank located in the jurisdiction of the seller (the confirming bank) that the latter bank will make the payment to the

seller. The payment is made upon the presentation by the seller to the confirming bank of certain documents identified in the LoC. These documents might include documents confirming title to the goods and bills of lading identifying the goods which have been transported or, in the case of a standby LoC, simply a written demand by the beneficiary without the need for any further documents. The confirming bank is itself entitled to compensation from the issuing bank upon presentation to it of the same documents.

In this way, the obligation of both the issuing bank and confirming bank to pay is separate, and independent, from the beneficiary’s obligations in its

underlying contract with the seller. The banks pay strictly in accordance with the terms of the LoC and do not need to concern themselves with whether or not the buyer and seller have met their contractual obligations to each other. A dispute over the sale of the goods does not impinge on the effectiveness of the LoC.

The fraud exception

The only exception to this principle recognised under English law is a fraud affecting the documents presented by the beneficiary (for example if they have been forged) or, in the case of a standby LoC, if the beneficiary had no honest belief in the validity of its demand. This exception arises, and the English courts will grant an injunction restraining the issuing/confirming bank from making payment, only in narrow and exceptional circumstances. To prove that a demand under a standby LoC is fraudulent, the applicant for an injunction (for example a buyer of the goods who alleges that the goods sold were defective) must show that the seller knows that the demand is fraudulent, or that the circumstances around the demand are such that the only reasonable inference is that the demand is fraudulent. The difficulty in meeting this threshold is demonstrated in the Court of Appeal’s decision in *National Infrastructure Development Co Ltd v Banco Santander SA* [2017] EWCA Civ 27 (*NIDCO v Santander*).

NIDCO v Santander concerned demands under four standby LoCs issued by Santander in favour of National Infrastructure Development Company Limited (NIDCO), a corporate vehicle of the government of Trinidad and Tobago, for carrying out public infrastructure works. The standby LoCs were security for payment obligations in a construction contract between NIDCO, and a contractor, Constructora OAS Limited (OAS). A dispute arose between NIDCO and OAS and OAS ceased construction work claiming non-payment and commenced arbitration against NIDCO. NIDCO subsequently made a demand under the standby LoCs, the terms of which required NIDCO to confirm that payment “is due and owing ... by [OAS]”. OAS sought and obtained an injunction from a court in Brazil (where Santander had a subsidiary) restraining payment by Santander under the standby LoCs. The standby LoCs were governed by English law and contained English jurisdiction clauses, and NIDCO subsequently sought summary judgment in the High Court against Santander for payment of the sums.

Santander argued that the fraud exception should be engaged because

- NIDCO’s certification that the sums were “due and owing” was false and that NIDCO could have had no honest belief it was true as no damages had yet been liquidated or awarded by the arbitral tribunal;
- NIDCO was claiming approximately USD 35m when it was only entitled to USD 31m in security and it was fully aware of this;
- There was potentially an equitable jurisdiction in English law to prevent unconscionable demands under LoCs, in addition to the fraud exception, and;

- There should be a stay of execution pending further order in light of the Brazilian injunction which prevented Santander from making payment.

The Court dismissed this argument and granted summary judgment in favour of NIDCO.

In the Court of Appeal, Santander argued that there was no evidence that personnel at NIDCO had considered whether sums were presently “due and owing” or would become “due and owing” at some future date. The court dismissed this argument, however, finding that: “No doubt lawyers can have a debate as to whether a current entitlement to claim damages for repudiation entitles one to say that the amount of such damages is due and owing ... but it borders on the absurd to say that the only realistic inference from the fact that business did not have (or may not have had) that debate is that they could not have believed in the validity of their demands.”

The end result of *NIDCO v Santander* was that the English courts required Santander to satisfy the LoC demand even though the Brazilian courts had granted an injunction forbidding payment. We examine the consequences of this further below.

Unconscionable demands

Although the English courts continue to resist efforts to extend the fraud exception to cover unconscionable demands, other jurisdictions such as Australia (where the unconscionable conduct ground has been incorporated into statute) and Singapore have been willing to do so. Similarly, in *NIDCO v Santander*, the Brazilian court granted an injunction restraining Santander from making payment on exactly the same facts which the English courts

dismissed with the words: “the facts and matters put forward as evidence of fraud to my mind just do not amount to fraud at all”.

These differences in approach can give rise to real difficulties for banks involved in LoC transactions, especially given LoCs commonly do not include any express choice of governing law or jurisdiction. The contractual relationships between the various parties (for example, between the applicant and the issuing bank, the issuing bank and the confirming bank, and the confirming bank and the beneficiary) are often governed by different laws and subject to different jurisdictions.

To take an example, in the absence of an express choice of governing law, an LoC between a Brazilian applicant and a locally-based bank is likely to be governed by Brazilian law, but if an English-based confirming bank steps in and confirms the credit in favour of the beneficiary, the confirming bank’s relationships with the issuing bank and the beneficiary are both likely to be governed by English law (see *Bank of Baroda v Vysya Bank Ltd* [1994] 2 Lloyd’s Rep 87). As demonstrated in *NIDCO v Santander*, a Brazilian court may be more willing than an English court to grant an injunction restraining an issuing bank from making payment to a confirming bank. That might leave a confirming bank in the unfortunate position of being ordered by the English court to pay the beneficiary, knowing that the issuing bank is prevented under the Brazilian injunction from reimbursing it. Or, possibly even worse, it may be bound by two contradictory rulings in two jurisdictions, so that it will inevitably breach at least one of them.



Conclusion

As noted, the drafters of LoCs generally refrain from including governing law and jurisdiction clauses. This is because the LoC typically includes an express provision subjecting it to the terms of the International Chamber of Commerce’s “Uniforms Customs and Practice for Documentary Credits” (UCP), a body of rules on the issuance and use of LoCs which applies to over 100 countries. In doing so, drafters put their faith in the idea that the UCP provides for standardisation that transcends the differences that may arise through the application of different national laws. *NIDCO v*

Santander shows that this is often not the case. Significantly, the UCP is silent as to governing law.

Given the varying approaches of different laws and jurisdictions to issues such as the motivation behind a beneficiary’s presentation of documents, good commercial practice suggests it would be prudent to include an express choice of governing law and jurisdiction in LoCs, even where they refer to the UCP. This would mitigate the risks of finding themselves trapped between contradictory judgments.

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Financial institutions: addressing misconceptions about arbitration

In the previous edition of the *Banking and finance disputes review*, we commented on the increased use by financial institutions of international arbitration to resolve disputes (as identified in a 2016 ICC Commission Task Force Report). Elsewhere in this edition, we discuss the new popular trend of investment arbitration for banks and financial institutions. In this article, we go back to basics to address and challenge some preconceptions about arbitration. In particular, we examine arbitration issues identified by the ICC Commission Task Force as being little understood or frequently misunderstood by banks and other financial institutions.

Pre-conception No. 1: Arbitrations are easily and widely enforced

The most common reason cited for preferring international arbitration over court litigation is the perceived ease of enforcement of arbitral awards in comparison to foreign court judgments. This perception is generally justified. The New York Convention on Recognition and Enforcement of Foreign Arbitral Awards (the “New York Convention”) has over 150 signatories and provides that foreign arbitral awards should be enforced in signatory states, subject only to limited grounds for refusal. For financial institutions, who might want to enforce the award against assets in a wide variety of jurisdictions, or whose counterparty

might be in an emerging jurisdiction where enforcement rights of foreign court judgments are uncertain, this is certainly a significant advantage.

However, banks should consider at the outset the likely jurisdictions where any award might ultimately be enforced. Most countries, including the United Kingdom, adopt a very limited interpretation of the exceptions to enforcement set out in New York Convention. But some countries, particularly those that have less experience of international arbitration, do not. The practical challenges of enforcement are greater in those countries, even with the benefit of the New York Convention regime. If a bank is concerned about enforcing a judgment in a certain

jurisdiction then arbitration is not necessarily a complete panacea as ultimately it is those same courts that will be called upon to enforce an award and they may adopt a similarly hostile approach to enforcement under the New York Convention.

Pre-conception No. 2: Arbitration is final

Financial institutions often cite the limited avenues of appeal as an advantage of international arbitration, bringing about a speedy resolution to the dispute and reducing cost. Again, this is a case of “true, but ...”.

Institutional arbitration precludes appeals on the factual merits and, if the parties have so agreed and with certain exceptions, it also precludes appeal on the legal merits. The arbitration agreement itself may also proscribe appeal rights. However, the law governing the arbitration proceedings may impose mandatory provisions that include rights of appeal. Under English law, for example, the parties may challenge an award for procedural irregularity or lack of jurisdiction or resist enforcement for public policy reasons. These rights are mandatory and cannot be waived by agreement, though they can be lost by conduct – for example, failing during the proceedings to object to the conduct complained of. Parties must also have first exhausted all available processes of appeal or recourse within the arbitration.

Although these challenges might not involve a reconsideration of the merits, they still detract from the finality of awards since they involve time and cost and may delay enforcement. In practice, these challenges rarely succeed in English courts and are rarely used. However, other jurisdictions without the same safeguards may be less reluctant to interfere, resulting in more of a threat to the integrity of the arbitral process.

Pre-conception No. 3: Arbitration does not provide for summary judgment

Banks often prefer litigation for claims where there is little or no prospect of a successful defence, such as a simple debt claim, because they assume that arbitration does not allow summary procedures. The ICC Commission Task Force reported that counsel at financial institutions were frustrated by experiences of arbitration where they were forced to go through a full consideration of the merits of a dispute, even where there are no contested facts. Banks perceive this as a significant disadvantage versus the summary judgment procedure available, for example, in the English courts. However, arbitration can include something similar to summary judgment – either through party autonomy or as set out in arbitration rules. And, in any case, considerations of enforceability may dictate against using summary judgment in litigation or arbitration.

The principle of party autonomy in arbitration means that parties are free to specify how they want their disputes to be resolved in their arbitration agreement. So, for instance, they can choose to give the tribunal the power to grant summary judgment. Or they can provide for an award to be rendered within a specified period following an expedited procedure by reference to documents only. Expedited procedures

can replicate in an arbitration many of the benefits of the summary judgment procedure.

Arbitral institutions are also taking steps to address the absence of summary judgment. The latest version of the ICC arbitration rules contain a form of expedited procedure. The SIAC launched a procedure akin to summary judgment in the 2016 edition of its arbitration rules. The HKIAC is currently consulting on introducing a similar procedure and other arbitration centres are expected to follow. This trend, combined with the parties' freedom to tailor the arbitral process to their needs, means arbitration is increasingly capable of resolving disputes in a summary or expedited manner.

Even without specific provisions in an arbitration agreement or arbitration rules, arbitrators arguably derive a power to strike out the case, or make a summary judgment, from their general case management powers (see *Travis Coal Restructured Holdings LLC v Essar Global Fund Ltd* [2014] EWHC 2510 (Comm)). But, given the lack of a significant body of cases on this issue, it is unlikely that an arbitrator would dispose of the claim summarily without an express power to do so under an arbitration agreement or institutional rules.

Care must be taken – in both litigation and arbitration – to ensure that use of a summary procedure does not threaten the enforceability of the award or judgment. For arbitration, the award must be enforceable under the New York Convention regime. This means ensuring that use of a summary procedure does not render an award susceptible to challenge for lack of procedural fairness in any jurisdiction where the award may be enforced.

Pre-conception No. 4: Arbitration does not provide for interim remedies

Financial institutions often need urgently to preserve the status quo pending resolution of a dispute, for instance to safeguard security. Arbitrators are perceived to lack the capacity to offer interim remedies, so that only court can preserve rights while the arbitration proceeds.

Arbitral institutions have made significant progress in interim remedies. Most major institutions now offer parties the right to apply for the appointment of an emergency arbitrator who can grant interim remedies such as injunctions on an urgent basis. Alternatively, parties can apply to expedite the appointment of the substantive tribunal. Under the English Arbitration Act, the tribunal has broadly similar powers to the court in relation to interim remedies (in fact, tribunals arguably have a wider discretion in granting interim relief). This reduces the need for court involvement and allows relevant issues to be dealt with by the same tribunal which will ultimately decide the case, saving time and expense. Although in practice parties tend to comply with arbitral orders, in the event of default, only the court could enforce interim relief granted by arbitrators. This highlights the importance of the choice of seat: it is the supervising court which gives the tribunal's interim order teeth.

Court relief may still be necessary or desirable. Courts can grant orders binding third parties or ex parte relief or an order under a penal notice. English courts are willing and able to act in support or supervision of arbitral proceedings, so again, the mere fact that the parties have chosen to arbitrate disputes does not necessarily mean that they cannot obtain interim court relief.



Pre-conception No. 5: Arbitration is confidential

Financial institutions often cite the appeal of the confidentiality and privacy of arbitration proceedings. But arbitrations are not always or automatically confidential. Depending on the seat, the default position might be that the arbitration is not confidential. If a financial institution wants their arbitration to remain private, they should specify so in the arbitration clause.

Another particular concern of financial institutions is balancing confidentiality with the need to establish precedent. This is especially so in the derivatives and bond markets, where there is appetite for rulings that set a precedent for future disputes and increase legal certainty. Although there is no system of precedent in commercial arbitration (the position is somewhat different

for investment arbitration), this issue has been put in the spotlight by recent (controversial) judicial criticisms. Arbitral institutions are taking steps to improve transparency in the market by publishing redacted awards in some cases. For example, the Stockholm Chamber of Commerce and the ICC Court of Arbitration publish select awards with the parties' consent. Published awards are redacted, such that confidential information and the names of the parties are removed, but the facts, reasoning and decision are made available. Therefore arguably a body of arbitral "precedent" is developing. Despite the fact arbitrators are not bound by awards made by other tribunals, this is an interesting development in striking an appropriate balance between improving transparency, developing the common law and practice in financial markets, and preserving confidentiality.

Pre-conception No. 6: Unilateral or asymmetrical arbitration clauses lack legal certainty

Financial institutions may want to retain the flexibility to choose litigation for some disputes and arbitration for others, using a so-called "asymmetric clause". These clauses are frequently viewed with a degree of scepticism, with the perception that they lack legal certainty.

This perception is justified: the validity of asymmetric clauses is not clear cut. Whilst in some jurisdictions courts routinely enforce such clauses, in others they have been hesitant to do so or have rejected them on grounds of public policy or access to justice. Although the LMA loan agreement contains an asymmetric clause (and English law has no problem with such clause), specialist advice should be sought where there is an international

element, particularly regarding the seat or any enforcement court. We have written previously on the enforceability of asymmetric arbitration clauses agreed between sophisticated parties in a number of key jurisdictions. See *Asymmetric arbitration agreements in the October 2017 International arbitration report*.

Pre-conception No. 7: Arbitration is straightforward for multi-party and/or multi- contract disputes

The rules of most major institutions now contemplate consolidation of multiple arbitrations into one arbitration or conducting multiple arbitrations concurrently (where the proceedings are procedurally managed as a single arbitration but separate awards are issued in each).

This gives the impression that arbitration in complex transactions involving multiple parties and contracts is straightforward.

In fact, these rules are not a silver bullet. Financial institutions should ensure that they are compatible with all the arbitration agreements in their transaction documents, or else face unpredictable results. For example, there might be confusion over who (if anyone) is entitled to appoint an arbitrator. Whilst rules on consolidation and concurrency provide a platform for multi-party and multi-contract arbitration, specialist input is essential when drafting the various arbitration agreements. In addition, a tribunal with particularly strong case management powers is key to handling complex procedures successfully.

Conclusion

In many ways, international arbitration is a powerful tool at the disposal of financial institutions. The flexibility to determine procedure, the widespread enforcement of awards and the finality of decisions should be attractive to banks and other participants in financial markets. However, timely and effective specialist advice should be sought throughout the process, from drafting the arbitration agreement through to enforcing the award, to ensure a correct fit and maximise the value that financial institutions achieve from arbitration.

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Investor State Dispute Settlement in the banking and finance sector

Investment arbitration is becoming increasingly popular amongst banks and financial institutions. This was the conclusion of an ICC Task Force investigating arbitration use amongst financial institutions and other players in the finance sector that reported at the end of last year. Financial institutions, which have traditionally tended to resolve disputes by litigation in jurisdictions hosting recognised financial centres, are turning their attention to international commercial arbitration, and, in appropriate cases, to investment arbitration or Investor State Dispute Settlement (ISDS). In this article, we analyse the relevance of ISDS for financial institutions and seek to identify trends from ISDS cases in the financial sector.

What is ISDS?

Investment treaties are agreements between states in which they each agree to provide certain minimum standards of protection to investors from the other state when they make investments in the host state jurisdiction. There are over 3,000 such treaties in place globally, and they frequently provide for a range of protections materially beneficial to financial institutions and/or the project companies or investment vehicles through which they may invest.

Investment treaties typically prohibit bias on grounds of nationality, guarantee fair and equitable treatment (FET) and the free transfer of funds, and grant rights to compensation in

the event of state expropriation of assets. Protection against state actions that undermine ownership or economic interests are of particular importance to banks and financial institutions. Critically, claims for breach of these protections arise under the treaty in accordance with principles of international law, independently of any contractual claims, and often give rise to a direct right to arbitrate such claims against the host state in a neutral forum. There are a number of procedural frameworks for investment treaty arbitration including

- The International Centre for Settlement of Investment Disputes (ICSID) Arbitration Rules or ICSID Additional Facility Rules

- Ad hoc arbitration (most commonly under the UNCITRAL Rules) or
- Less commonly, proceedings under the rules of a specific arbitration centre such as the International Chamber of Commerce Court of Arbitration (ICC).

How is ISDS relevant to banks?

There are three substantial reasons for the growing relevance of ISDS to financial institutions.

Substantive investment treaty protection

Firstly, financial institutions and their advisers are increasingly aware of, and structuring their foreign investments or financial instruments in such a way as to avail themselves of, substantive protections available to foreign investors under investment treaties.

Advantages of arbitration

Secondly, investor-state arbitration and arbitration generally are increasingly attractive to financial institutions, with recent reforms addressing some of the disadvantages. For a discussion of international commercial arbitration and its increasing relevance to financial institutions, *see Financial institutions and international arbitration in the February 2017 Banking and finance disputes review*.

In particular, arbitration offers a neutral forum for dispute resolution.

This is particularly attractive in emerging markets where local courts might be perceived as unreliable or susceptible to bias. Such risks become more acute where the host state is a counterparty.

In an ISDS context, there is the additional advantage that whilst proceedings generally take place in private and share many of the procedural advantages of commercial arbitration, such as parties' involvement in choosing the constitution of the tribunal for example, final awards are generally made public. The risk to the host state's reputation as a recipient of foreign investment may give an investor negotiating leverage.

Furthermore, arbitral awards are often more readily enforced than court judgments. ICSID awards are subject to the enforcement regime under the ICSID Convention, with compliance linked to access to World Bank funding.

Increased regulation

Thirdly, following the sub-prime and Eurozone crises, many states moved to a more interventionist approach to regulation, including concerted efforts to tighten regulatory frameworks. Typical policy changes include austerity measures, sovereign debt restructuring, regulatory intervention and bank bailouts. This has resulted in significant change in the legal environment for many foreign investors, with financial institutions being amongst the entities most sensitive to increased regulation.

Many of these measures have been taken by states in order to protect global economic stability, in a way not contemplated by the negotiators of investment treaties. Nevertheless, the unprecedented level of state intervention in the financial sector has provided and may yet further provide banks and financial institutions with claims under investment treaties that they would not be able to pursue outside of the ISDS framework.

How have banks used ISDS?

The three factors set out above can be seen emerging as trends in recent investment arbitrations involving financial institutions.

Most recently, in September 2017, two claims by Austrian banks have been registered by ICSID (*Raiffeisen Bank International AG & Raiffeisenbank Austria d.d. v Croatia* (ICSID Case No. ARB/17/34) and *Addiko Bank AG v Montenegro* (ICSID Case No. ARB/17/35)) in the wake of the fall-out from the Swiss central bank's decision to abandon exchange rate controls in 2015. That decision briefly caused turmoil in financial markets by removing caps on the value of the Swiss franc and prompting both Croatia and Montenegro to pass legislation compelling the conversion of franc-denominated loans into Euros. UniCredit has also brought claims.

A decided case stemming from the fall-out and changing regulatory landscape in the wake of the global financial crisis is *Poštová banka, a.s. and ISTROKAPITAL SE v. Hellenic Republic* (ICSID Case ARB/13/8, Award April 9, 2015). The dispute arose from downgrading of Greek debt from 2009 and the adoption by the Greek government of austerity measures and sovereign debt restructuring, including an exchange of outstanding government bonds for new titles. The claimants brought a claim against Greece for expropriation and breach of the fair and equitable treatment standard in the Slovakia-Greece bilateral investment treaty (BIT).

State bailouts and compulsory administration of banks have also led to a number of investment protection cases. In *Bank Melli Iran and Bank Saderat Iran v Bahrain* for example, Future Bank was placed into administration by Bahraini authorities in order to "protect the rights of depositors and

policyholders". This led to a claim by the banks under the Bahrain-Iran BIT. Similarly in *Hesham Talaat M. Al-Warraq v Republic of Indonesia* (Award December 15, 2014) and *Rafat Ali Rizvi v Republic of Indonesia* (ICSID Case ARB/11/13) claims arose out of the Indonesian government's bailout of a bank in which the claimants had allegedly invested (involving a similar fact pattern).

A proliferation of investor-state claims has also been triggered by state debt default, the most notable example being those brought against Argentina following that country's default and debt restructuring including *Abacat and others v Argentine Republic* (ICSID Case ARB/07/5, Decision on Jurisdiction and Admissibility August 4, 2011), *Ambiente Ufficio S.p.A and others v Argentine Republic* (ICSID Case ARB/08/9, Decision on Jurisdiction and Admissibility February 8, 2013) and *Giovanni Alemanni and others v Argentine Republic* (ICSID Case ARB/07/8, Decision on Jurisdiction and Admissibility November 17, 2014) brought under the Argentina-Italy BIT.

State actions arising out of political instability or transformation have led to recent claims by banks and financial institutions. A recent example of this is *PJSC CB PrivatBank and Finance Company Finilon LLC v The Russian Federation* (PCA Case No. 2015-21), a case brought before the Permanent Court of Arbitration (PCA) under the Russia-Ukraine BIT. The claimants alleged that Russia had breached its obligations under the BIT by preventing them from operating their banking business in Crimea. Another example is *Indorama International Finance Limited v Arab Republic of Egypt* (ICSID Case No. ARB/11/32), brought under the Egypt-UK BIT, seeking compensation for a foreign investment in the Shebin al-Kom textile factory, which had been privatised in 2007 during the Mubarak regime. In the wake of the protests that ousted Mubarak in 2011, factory workers

occupied the site to protest against working conditions and redundancies. A Cairo administrative court then ruled that the privatisation had been unlawful. Similarly, in *Saluka Investments v Czech Republic* (UNCITRAL Arbitration Rules, Partial Award March 17, 2006), the dispute arose out of the re-organisation and privatisation of the Czech banking sector to replace the centralised banking system of the Communist period.

In many of these claims, the primary allegation of state liability under the investment treaty is for expropriation without payment of fair compensation. Expropriation can be direct (formal takeover of investment) or indirect (actions equivalent to depriving the investor of the benefit of the investment).

Expropriation claims have also arisen from policies of nationalisation and compulsory acquisition rather than political transformation and reorganisation of the financial sector or restructuring of public debt. *Swissbourgh Diamond Mines (Pty) Limited, Josias Van Zyl, The Josias Van Zyl Family Trust and others v The Kingdom of Lesotho* (PCA Case No. 2013-29) concerned expropriation of the claimants' mining leases and *KT Asia Investment Group B.V. v Republic of Kazakhstan* (ICSID Case ARB/09/8), concerned forced nationalisation of the BTA Bank. In *Fireman's Fund Insurance Company v United Mexican States* (ICSID Case ARB(AF)/02/1, award July 17, 2006), brought under the North American Free Trade Agreement (NAFTA), the claimant alleged that the Government of Mexico had

expropriated its investment in Grupo Financiero BanCrece. Similarly, *British Caribbean Bank Ltd v Government of Belize* (PCA Case 2010-18, Award December 19, 2014) concerned the Government's compulsory acquisition of the claimant's interest in certain loan and security agreements.

Recent political change and the growth of nationalistic policies in a number of emerging markets, such as East Africa, as well as in Western markets, suggest treaty expropriation claims will continue to proliferate.

Conclusion

Investment treaties provide crucial substantive protections for banks and financial institutions investing in applicable foreign jurisdictions. ISDS is the mechanism which gives those protections teeth. It is a potential direct route to redress where host states fail to protect foreign investments in accordance with their treaty obligations.

Financial institutions are increasingly availing themselves of ISDS mechanisms to bring high-value claims that would not be available outside the investment protection system. ISDS claims also carry many of the advantages of arbitration as means of resolving disputes. Despite significant current political controversy and calls to reform existing ISDS models, it is likely that this area will continue to grow in importance and that banks and financial institutions will bring an increasing number of claims.

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Challenging governing law clauses: re-match in the Court of Appeal

Article 3(3) of the Rome I Regulation is an exception to the general rule that a choice of governing law clause in a contract will be upheld. It provides that where all other elements relevant to the situation at the time of the choice of law are connected with one country only, the mandatory laws of that country shall apply despite the choice of law of a different country.

Prior conflicting High Court authority on the scope of Article 3(3) has now firmly been resolved in favour of a restrictive interpretation. This has been confirmed by the recent Court of Appeal decision in *Dexia Crediop SPA v Comune di Prato* [2017] EWCA Civ 428 (*Dexia*). It follows the reasoning of the Court of Appeal in *Banco Santander Totta SA v Companhia de Carris de Ferro de Lisboa SA* [2016] EWCA 1267 (*Santander*).

Position before the *Dexia* Court of Appeal decision

In the last issue of *Banking and finance disputes review*, we saw how the competing High Court authority concerning the interpretation of Article 3(3) in *Dexia* and *Santander* had appeared to be resolved in favour of a narrow interpretation of the provision. This followed from the Court of Appeal decision in *Santander*, where it was held that the relevant elements to take into account when assessing whether all the elements are connected with a particular country include

elements which have an “international character”. Those elements do not have to point to or relate to another specific country. Accordingly, the use of the internationally accepted ISDA documents and entry into back-to-back swaps with a non-Portuguese counterparty were enough to mean that all the other elements of the situation did not just point to Portugal. That meant that Portuguese mandatory rules could not be relied on to escape the swaps and the effect of the English governing law clause was upheld.

Santander was in contrast to the reasoning of the High Court in *Dexia* which found that mandatory rules of Italian law did apply, in spite of an English governing law clause, because all relevant elements did point to Italy. The contrast with *Santander* was particularly acute as both cases involved use of the ISDA documentation and back-to-back hedging arrangements with cross-border parties. See *Challenging governing law clauses: New ideas in European public body litigation in February 2017 Banking and finance disputes review*.

At the time of the last article there was an ongoing appeal to the Court of Appeal in the *Dexia* litigation. That judgment has now been handed down.

Court of Appeal decision in *Dexia*

The Court of Appeal overturned the decision of the High Court in *Dexia*. The Court said that it was bound to follow the prior decision of the Court of Appeal in *Santander*. This closes the door on an attempt to widen article 3(3). If there is an element of the situation that is international in nature but not connected to a particular country, that will be enough to prevent a party from relying on Article 3(3). The trial judge was therefore wrong in *Dexia* to discount

- Dexia’s decision to enter into a back-to-back hedging swap with a non-Italian counterparty
- The use of the international standard ISDA Master Agreement

as elements “relevant to the situation” for the purpose of Article 3(3).

The Court of Appeal then had to assess whether all elements relevant to the situation at the time of the contract were in fact located in a country other than England (the country of the governing law clause). The Court of Appeal concluded that the relevant factors did not point exclusively to Italy, because

- The standard form of the ISDA Master Agreement immediately created an international element outside of any particular country. By itself, this would have been enough to preclude all the elements being related to one particular country outside of England (in this case Italy).
- The fact that back-to-back hedging was routine in these transactions and often with counterparties outside of the country of the main counterparty was a further relevant factor “showing just how international the swaps market actually is”. Further, there would be real uncertainty if different laws governed the original swap contract and the back-to-back hedging arrangements – it was exactly this kind of consideration that meant a restrictive interpretation of Article 3(3) that promoted certainty was to be preferred.
- An additional factor also pointing away from Italy was that non-Italian banks tendered for the original advisory contract that was ultimately awarded to Dexia.

In short, the Court of Appeal concluded that once an international element comes into the picture, Article 3(3) should have no application. In this case, there were multiple relevant international elements, each of which would have been sufficient on its own. In fact, there were fewer international elements in *Dexia* than in the previous Court of Appeal decision in *Santander*, so that *Dexia* may be seen as even stronger decision in limiting the scope of Article 3(3).

Commentary – certainty, but short lived?

This decision resolves a series of conflicting judicial decisions. It is a robust, commercial decision that will be welcomed by financial institutions and participants in the international derivatives markets. For back-to-back arrangements to be relevant, it was not even necessary to show that the parties foresaw that the bank might hedge the swaps with non-Italian counterparties – it was sufficient simply for cross-border hedging to be a routine part of the market.

Of course, greater certainty in the application of one Article in the Rome Regulation is overshadowed by the greater unknown of Brexit and its implications for choice of law. At present, the aim of the Government (as set out in their future partnership paper on *Providing a cross-border civil judicial cooperation framework*) is to incorporate the Rome I Regulation into domestic law. This option would minimise any disruption. In any case, *Dexia* provides a positive short-term distraction from the Brexit negotiations.

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Thomas v Triodos: revisiting the duties of care owed by banks

The “mezzanine” duty is a potential trap for financial institutions transacting with customers on a non-advisory basis. More than a duty not to mislead but less than a duty to advise, the mezzanine duty is an awkward amalgam but one that the courts are increasingly likely to deploy.

In *Thomas v Triodos* (*Thomas v Triodos*), a bank was held liable for mis-selling an interest rate derivative to its customers, despite it being a non-advised transaction. The High Court, considering the spectrum of duties of care that banks owe to their customers when selling financial products, held that in certain circumstances banks owe customers a higher duty than simply not misleading or misstating information – even if the relationship is not advisory. Such a duty arose on the facts of *Thomas v Triodos*, in particular because the defendant bank had voluntarily subscribed to a code of conduct called the Business Banking Code (BBC) and had advertised its subscription to the claimant customers.

Facts

The claimants (Mr and Mrs Thomas) ran a successful organic farming business. In 2006, they transferred their borrowing to the defendant (Triodos Bank) due to its reputation for supporting businesses with strong green credentials.

In June 2008, the claimants decided to switch, via two tranches, a sizeable portion of their borrowing from a variable rate to ten-year fixed rates of 6.71 per cent and 7.52 per cent per annum, respectively. In the letters that the defendant provided to the claimants confirming the two fix arrangements, it had informed them that it subscribed to the BBC (this was also in its general literature).

In September 2008, base rate started falling, reaching a low of 0.5 per cent by March 2009. When the claimants sought to return to the variable rate, they were told that this would incur a substantial redemption penalty of approximately £96,000. The claimants brought a claim against the defendant for positively misrepresenting the financial consequences of prematurely leaving the fixed rate. The Court ruled in the claimants’ favour, finding that the defendant had breached its duty of care to clearly explain to them, when asked, the financial implications of entering into the fixed rate arrangements as it had been obliged to do under the BBC.

The standard duties of care owed by banks

Case law has expressly recognised the existence of two types of duty owed by banks to customers when selling financial products

- When providing advice, the duty to ensure that such advice is full and accurate and, in some cases, to comply with the relevant regulatory regime.
- When providing information only, the duty to take reasonable steps not to misstate or mislead in accordance with *Hedley Byrne* principles (*Hedley Byrne & Co Ltd v Heller & Partners Ltd* [1964] AC 465).

It was held in cases such as *Green & Rowley* [2013] EWCA Civ 1197 and *Thornbridge v Barclays* [2015] EWHC 3430 (QB) that, in the absence of an advisory relationship and the provision of advice, the only duty of care that a bank owes is a *Hedley Byrne* duty. In determining whether advice or information has been provided, *Rubenstein v HSBC* [2011] EWHC 2304 (QB) held that one should look to whether the information was provided with a recommendation.

The emergence of the “mezzanine duty”

An intermediary duty – higher than that prescribed by *Hedley Byrne*, but not so high as the advisory duty – was first identified in *Crestsign Ltd v National Westminster Bank* [2014] EWHC 3043 (Ch), another mis-selling case. In that case, the relationship was non-advisory due to a disclaimer in the bank’s terms and conditions (despite the bank having provided unsuitable advice to the customer). Nevertheless, the bank owed the customer a so-called “mezzanine duty” to explain fully and accurately the nature and effect of the product once the bank’s representative had volunteered to explain it. In coming to this decision, the Court looked to the judgment of Mance J (as he then was) in *Bankers’ Trust International v PT Dharmala Sakti Sejahtera* [1996] CLC 518 which stated that if a bank provides an explanation or tenders advice, it must provide that explanation or tender that advice fully, accurately and properly.

However, some confusion followed *Crestsign* as first instance judges disagreed whether a “mezzanine duty” actually existed. In *Thornbridge* (which was decided after *Crestsign*), Moulder J confined Mance J’s statement to the facts of that case – otherwise the statement would in effect have “elevated the duty of a salesman to that of an adviser.” In *Property Alliance Group Limited v The Royal Bank of Scotland* [2016] EWHC 3342 (Ch),

Asplin J accepted that a duty wider than the duty not to misstate could arise, although it would fall “on the advisory spectrum”. Meanwhile, the appeal in *Crestsign* was compromised before it was heard; interestingly, the defendant bank did not cross-appeal against the finding that there was, indeed, a “mezzanine duty”.

Thomas v Triodos was therefore an opportunity for the courts to provide clarity as to what was meant by the term “mezzanine duty”, and under what circumstances it would arise.

What duty of care was owed in *Thomas v Triodos*?

On the facts, the Court was satisfied that the relationship between the claimants and the defendant was not advisory, and that no advice had been given; further, the Financial Services and Markets Act 2000 did not apply as fixed rate lending per se is not a regulated activity (even if it did, it was doubtful that the claimants would have qualified as private persons in order to have a right of direct enforcement of various COBS Rules under s.138D of FSMA, as they were in business as a farming partnership). However, the Court felt that the defendant clearly owed the claimants a *Hedley Byrne* duty to take reasonable care not to misstate or mislead the claimants on any facts on which the claimants could be expected to rely. The question was whether the bank’s duty of care

when providing the claimants with information went further than a simple duty not to misstate or mislead. Judge Havelock-Allan Q.C. said that this would “depend on the particular facts and whether, as a matter of policy, it is thought appropriate to impose such a duty in the circumstances” (para. 78).

The Court took note of the defendant having subscribed to the BBC. It contained a number of prescribed responsibilities, including the requirement to provide customers with “a balanced view of products so that they have an accurate understanding of the financial implications” in plain English. This “balanced view” was “especially important for long-term financial commitments (for example, the costs of withdrawing early from a fixed-term loan...where this is allowed)...”. There were no disclaimers, “basis” clauses or exclusions negating the defendant’s responsibility for the BBC. As such, the Court held that the defendant owed the claimants more than a duty not to mislead or misstate, and that this duty was to explain in plain English to the claimants, when asked by them, the financial implications of entering into a fixed rate arrangement. The Court stressed that this was not a duty to volunteer information if not asked, nor to provide a comprehensive tutorial.

The Court ruled that the defendant was in breach of this “mezzanine duty”. It had failed to provide the claimants with a balanced picture of

the consequences of entering into the fixed rate arrangements, including the relationship manager not disabusing Mr Thomas of his suggestion that £10,000–£20,000 was the realistic redemption figure. The Court held that this was a misrepresentation which had influenced the claimants’ decision to enter into the first fixed arrangement; significantly, the Court also held that even if it was not an instance of misrepresentation, the “mezzanine duty” was breached because the relationship manager should have realised when the claimants asked about the redemption clause that they did not understand how it worked. The breach of the “mezzanine duty” persisted in the second fixed arrangement as there was no evidence the defendant’s Loan Administrator had provided the balanced picture that he was required to do under the BBC.

They should review any policies or voluntary codes of conduct to determine their additional (if any) information responsibilities beyond the basic *Hedley Byrne* duty. Banks should also ensure that staff, including relationship managers, are aware of their responsibilities under any policies and/or codes and understand their remit, including the correct processes for volunteering explanations of products. Above all, banks should include exclusions in the form of “basis clauses” in their terms and conditions as a powerful first line of defence.

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Where does this leave banks?

Although the decision in *Thomas v Triodos* may still be appealed – and would undoubtedly benefit from further review and clarification by a higher court – banks should consider whether a “mezzanine duty” arises whenever giving information on financial products to customers.

CGL Group Ltd v Royal Bank of Scotland Plc [2017] EWCA Civ 1073

The Court of Appeal has held that banks carrying out reviews of sales of interest rate hedging products pursuant to agreements with the Financial Conduct Authority (FCA) did not owe a duty to individual customers to carry out those reviews with reasonable skill and care.

Facts

The appellants were required to buy interest rate hedging products as a condition of loans made to them by the respondent banks. The FCA's view was that there had been serious failings in the selling of those products to small and medium sized businesses. As an alternative to enforcement action, the FCA required the respondent banks to carry out reviews of sales of interest rate hedging products to "non-sophisticated customers". The banks were to review sales from December 1, 2001 and provide appropriate redress to customers where there was found to be mis-selling. The "Review Agreement" entered into by the FCA and the banks was announced in June 2012, but was not published by the Treasury Select Committee until February 2015.

The banks decided during the course of their reviews that the appellants were not entitled to any redress. The appellants put forward their claims differently, but each appellant claimed

that the respondent banks had mis-sold them the interest rate hedging products and owed them a duty of care when carrying out the reviews of the sale of those products.

Arguments

The appellants' main argument was that the banks had voluntarily assumed responsibility to their customers, based on letters sent to the appellants explaining the review to be carried out, or even simply by entering into the Review Agreement with the FCA. The appellants also argued that it was fair, just and reasonable for there to be a duty because it promoted the object of the reviews, which was "to make amends for past conduct".

The banks argued that they had not assumed responsibility by sending the letters to the customers or by opting into the reviews. They argued that the letters invited the customers to rely on the FCA and the independent reviewers, rather than the banks.

The fact that the reviews were being undertaken in the context of the FCA exercising its regulatory powers, and there was an independent reviewer, indicated that there was no duty of care owed by the banks to their customers. The banks also sought to rely on a particular clause in the Review Agreement. This clause stated that persons other than the FCA and the relevant bank were to have no right to enforce any term of the Review Agreement. It was also argued by the banks that the imposition of a duty of care would undermine the law of limitation as customers would be able to bring claims outside the limitation period for the original mis-selling.

Decision

The Court considered the following three tests to determine whether the banks owed the customers a duty of care

- The assumption of responsibility test.
- The threefold test in *Caparo Industries Plc v Dickman* [1990] 2 AC 605 – this asks whether (a) the loss was a foreseeable consequence of the defendant's actions or inactions; (b) the relationship of the parties was sufficiently proximate; and (c) it would be fair, just and reasonable to impose a duty of care on the defendant towards the claimant.

- Incremental additions to the existing categories of duty.

The Court said that these tests can be considered together and, regardless of the test applied, it was important to focus on the circumstances of the case and the relationship between the parties.

The leading judgment was given by Beatson LJ and sets out the following factors which indicated that no duty of care was owed by the banks:

The regulatory context

The Court's view was that the imposition of a duty of care would "undermine a regulatory scheme which has carefully identified which class of customers are to have remedies for which kind of breach" and this would therefore go against the intention of Parliament as set out in the regulations. The Court noted the FCA's powers as regulator and that it was the FCA's responsibility to bring enforcement proceedings if a bank fails to comply with the terms of a review agreement.

The dealings between the parties and the context of those dealings

The appellants sought to rely on communications that "crossed the line" between them and the bank. The Court's view was that the banks owed a contractual duty to the FCA only (which obliged the banks to allow the appellants to participate in the reviews) and the letters were drafted pursuant to the FCA's requirements. The reviews were not voluntary, but instead "thrust on them" as an alternative to enforcement action by the FCA. This weighed against there being an assumption of responsibility by the banks. The banks had sought to rely on a clause of the Review Agreement which stated that persons other than the FCA and the relevant

bank were to have no right to enforce any term of the Review Agreement. The Court thought that as this clause did not purport to exclude or limit liability for negligence, it was not itself inconsistent with an assumption of responsibility by the banks.

The role of the "skilled person" independent review

It was difficult to argue that the banks assumed responsibility when customers were informed that a skilled person (appointed under section 166 of the Financial Services and Markets Act 2000) would be examining the banks' decisions. The banks had less control over the conduct of the reviews than the independent reviewer, who did not owe a duty to customers.

The threefold and incremental tests

The Court held it was not "fair, just or reasonable to impose a duty", given the nature of the reviews and the limitations on remedies available under the regulatory regime. Nor was there a lacuna which justice required should incrementally be filled by a duty of care (as any gap in the remedial framework reflects the considered decision of Parliament). The Court was conscious that imposing a duty of care in respect of a complaint system could have far reaching consequences and would enable two of the appellants to circumvent the limitation period for the original mis-selling claim.

Conflict of interest

The conflict of interest (in that the banks were reviewing their own conduct) also pointed away from imposing a duty of care. The conflict of interest was why the FCA insisted upon the appointment of an independent reviewer.

Reliance

The terms of the Review Agreement were generally unknown until February 2015 at the earliest. A customer could not have been made worse off by the outcome of the review as it could still have pursued a mis-selling claim independently. Accordingly, the customers did not rely on the reviews.

Comments

The Court was reluctant to intervene where there was a statutory regulatory regime and showed consideration for the practicalities of the review process. Banks will welcome this decision as it prevents customers bringing negligence claims relating to the conduct of past business reviews. A contrary decision would have meant the conferral of additional rights on customers whenever banks agreed with the FCA to undertake past business reviews. This would have overlooked the fact that these past business reviews are by their very nature beneficial to customers and do not prevent them from enforcing their existing rights.

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Restricting permissible loan transferees: “Financial institutions” and *Argo Fund* revisited

In the present uncertain economic climate, many banks are transferring their contributions to loan facilities to the secondary debt market in order to replenish their cash reserves and improve liquidity. This has been seen particularly in shipping loans, where news of a number of banks disposing their loan assets has featured recently across the media.

Loan transfers are a concern for borrowers and disputes over proposed transferees arise commonly between borrowers and lenders. A borrower may be faced with the prospect of their lender becoming a third party with whom they have no commercial relationship and with whom they would not have chosen to have a lender/borrower relationship. A borrower has a genuine commercial interest in ensuring that it is not going to be disadvantaged by a transfer and by the identity of the new lender. It is for this reason that facility loan agreements generally contain provisions restricting changes to the lenders. Typically, the lender can only assign or transfer its rights to a defined class of permitted transferees. Loan transfer disputes often revolve around the interpretation of these restrictions on transfer.

The *Argo Fund* case

The standard 1997 Loan Market Association (LMA) loan agreement form (the “LMA Agreement”) had such a restriction. It stated that transfers

could only be effected to a “bank or other financial institution”. The LMA Agreement did not define the expression “bank or other financial institution”, but it was considered by the Court of Appeal in *Argo Fund Ltd v Essar Steel Ltd* [2006] 2 Lloyd’s Rep 134 (*Argo Fund*). *Argo* was a hedge fund incorporated in the Cayman Islands and held a portfolio of debt purchased mainly on the secondary market. It specialised in acquiring distressed debt at a discount and then pursuing aggressive enforcement strategies. *Argo* purchased a portion of *Essar*’s debt and when *Essar* defaulted it commenced proceedings seeking repayment of the entire debt plus interest. *Essar* argued that the transfer was invalid because the expression “a bank or other financial institution” was limited to transferees who were akin to a bank, active in the primary debt market and could not include institutions other than banks (i.e. hedge funds).

The primary question before the Court was whether *Argo* was an “other financial institution” and therefore a permissible transferee under the

loan agreement. Auld LJ held that the phrase “other financial institution” did not need to be a bank or akin to a bank. Rather, a transferee would be a financial institution if: (i) it had a recognised form of being; (ii) it carried out business in accordance with the laws of its place of incorporation; and (iii) its business “concerns commercial finance”. Rix LJ added that one of the “essential characteristics” of a financial institution was that it “regularly makes, purchases or invests in loans, securities or other financial assets” and suggested that the word “institution” must have “a certain substance”.

The decision in *Argo Fund* therefore sets a very low bar for transferees to qualify as financial institutions. According to that decision, a transferee will qualify merely if it has a lawful existence and carries on some form of commercial finance business. This test may have been appropriate given the particular circumstances: the borrower was in serious default and the Court considered the borrower’s application was a tactical effort to avoid its responsibilities. Later, in *British Energy Power and Trading Limited v Credit Suisse* [2008] 2 All ER (Comm) 524 Sir Anthony Clarke MR considered *Argo Fund* and observed that on the construction of “financial institution” adopted in that case, a “large number of entities, including hedge funds” would qualify as permitted transferees.

Revisiting *Argo Fund* – implications for hedge funds

But does the decision in the *Argo Fund* mean that hedge funds will constitute permissible transferees without any limitation? A first instance court will be bound by the Court of Appeal decision in the *Argo Fund* to apply the same lenient approach when considering whether a hedge fund is a “financial institution”. The following factors could nevertheless be used to distinguish *Argo Fund*:

Does the hedge fund carry out business concerning commercial finance?

In most cases (if not all) (i) a fund will be duly incorporated and (ii) the business carried out by the fund will be lawful in its place of incorporation, thereby satisfying the first two limbs of the definition set out in *Argo Fund*. The critical limb is whether a fund actually “carries out business” and, if so, whether that business concerns “commercial finance”. This is essentially a question of fact. For example, a limited liability asset-holding shell company arguably does not satisfy the definition. Equally, if an entity does not trade then arguably it does not carry on any business, whether in commercial finance or otherwise. Furthermore, such an entity would have no real substance, contrary to its description as an “institution”. Accordingly, borrowers should establish whether a proposed transferee does or will provide capital to financial markets through making or trading in loans, securities or other financial assets or whether it is incorporated specifically and solely for the purpose of the transfer of this particular loan and has no other business.

Has the loan been fully drawn and is the borrower in default?

It may be possible to distinguish *Argo Fund* if the loan is not fully drawn with the borrower in default. In that case, the Court viewed the borrower’s challenge to the transfer as a “device” to avoid honouring its debt and gave little weight to the borrower’s concerns about having a hedge fund as a counterparty. The borrower’s commercial relationship with an established bank with a presence in the shipping industry may carry more weight with a Court when the borrower is not in default.

Is the loan a term or revolving facility?

Given that *Argo Fund* sets a very low bar for transferees to qualify as financial institutions, there may be a risk that a lender transfers its commitment to a transferee who is incapable of fulfilling the primary lending obligation. In *Argo Fund*, Lord Justice Rix expressly refused to consider transfers associated with obligations to lend monies in the future (under a revolving facility, for example). A counterparty that owes obligations to the borrower is fundamentally different to one that is only the beneficiary of obligations and questions as to the commercial relationship and the nature of the transferee are clearly more relevant. Therefore, in these cases, a narrower definition of “financial institution” may be appropriate.

Contractual wording and other potential restrictions/conditions?

A borrower may argue that failure to satisfy a contractual condition invalidates any transfer, irrespective of the qualities of the transferee. For instance, it is not uncommon for facility loan agreements to require that the lender notifies the borrower of its intention to transfer or consults with the borrower or obtains its consent in advance of a transfer. There may be scope for a borrower to argue that

failure to satisfy a condition means that the transfer will have no legal effect. This will depend on the precise wording and the nature of the condition – although most conditions on transfer would be ineffective if a breach only led to a remedy in damages, breach of a purely administrative requirement may not invalidate the transfer. Of course, this argument is only available where a condition to transfer has not been satisfied. Where borrower consent is necessary before a transfer, the contract may only allow refusal on reasonable grounds and, even if the contractual discretion is expressed to be absolute, courts will generally forbid refusal where it would be irrational or take into account irrelevant considerations.

Implications for SPVs

The secondary loan market has recently seen an expansion in lenders transferring their loans to SPVs. Any transfer to an SPV of a loan subject to the standard LMA Agreement restriction will have no legal effect if the SPV does not fall within the definition of a “financial institution”, which will depend on the same considerations as discussed for hedge funds above.

A more interesting and increasingly common scenario is when the lender seeks to transfer the loan to a group of hedge funds which, in turn, will transfer the loan to an SPV. Although the SPV, taken in isolation, is not a financial institution, it may satisfy the LMA Agreement restriction if it is established by the hedge funds as a structure through which to carry on their usual business, albeit on a joint basis. The argument is that the combination of the funds and the SPV is a legitimate structure which allows the funds to undertake business together; and that, accordingly, when considering whether the SPV is a financial institution, the Court should

focus on whether the structure as a whole meets that definition, rather than simply the SPV in isolation. If an individual hedge fund can be a financial institution, then the same should apply to an entity set up by two or more hedge funds to carry on business on a joint basis. The strength of this argument will depend on circumstances such as whether the SPV was part of an established structure with a trading history at the time of the transfer and whether the SPV is a subsidiary of one of the hedge funds or related to them more remotely.

Conclusion

The trend for banks to transfer their commitments under loan facility agreements to the secondary market is likely to continue and the number of unconventional entrants to the secondary market, including funds investing directly and through SPV structures, is similarly increasing. Borrowers have a legitimate commercial interest in the identity of any transferee and maintaining their commercial relationships. Therefore, disputes may well arise when a lender seeks to transfer its loan commitment. While *Argo Fund* sets a very low threshold for transferees to qualify as “financial institutions”, the distinguishing factors set out here might be used by borrowers in disputes over loan transfers.

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