

DERIVATIVES CLAIMS AGAINST BANKS

This article deals with key aspects of recent Court decisions regarding swaps/other derivatives and mis-selling and identifies arguments to support claims by investors, as well as bank defences.

1. Introduction

In recent years, there have been two important types of litigation about financial services products:

- ***mis-selling cases*** - investors (either individuals or their trading companies) have brought claims against banks, alleging that the banks breached a duty to advise them about the nature and risks of the investments, or that the banks misrepresented the nature of the investments. The case of *Springwell Navigation Corp v J P Morgan Chase Bank*¹ is a well-known example.
- ***specific claims in relation to derivatives*** - some of the cases also involve mis-selling of derivative products. Some others involve the capacity of municipalities to enter into interest rate swaps.

2. Was the bank an adviser or salesman?

Investors may argue that the bank acted as an adviser and that it had a duty to advise the investor in relation to the suitability of the investments. In *Springwell*, the court² said that there was a difference between a stock trader (a salesman) and an investment adviser. The question was did a salesman giving recommendations have the obligations and duties of care of an investment adviser — in particular, did he have a duty to give advice on a wider basis as to the structure of the portfolio.

The court said that relevant factors to decide whether a duty of care existed included: (a) the contractual context; (b) the salesman's role; and (c) the client's level of sophistication.

On the facts of the *Springwell* case, the Court decided that there was no duty on the bank to advise. This was primarily because although the salesman made recommendations, the investment decisions were made by the investor and it was a sophisticated investor that had successfully dealt in that market on previous occasions. Further, there was no written agreement between the parties indicating that the bank would give advice. Indeed, the contract said that there was no duty and in the contract the client stated that it was not relying on the bank and was making its own decisions.³

However, even though the Court in *Springwell* said that the bank had no duty of care to the customer each case depends on its particular facts. In *Springwell*, it was highly relevant that the client was a sophisticated, experienced investor in the particular industry in question. In other cases that will not be so.

If a bank does give advice, then it will normally have a legal duty to do so "fully, accurately and

¹ [2010] EWCA Civ 1221; [2010] 2 CLC 705.

² This was the decision of Gloster J at the first instance; [2008] EWHC 1186 (Comm). This aspect of the case (the duty to advise) was not appealed. This line of reasoning (on the distinction between a salesman and an adviser) was recently followed by the court in *Standard Chartered Bank v Ceylon Petroleum Corp* [2011] EWHC 1785 (Comm).

³ Other cases have also recognised the parties' ability to contract on a basis which precludes the existence of a duty to advise: see, eg, *IFE Fund v Goldman Sachs International* [2007] Lloyd's Rep 449 (CA) and *Titan Steel Wheels Ltd v Royal Bank of Scotland plc* [2010] 2 Lloyd's Rep 92.

properly".⁴ It will be easier to show that a bank has a duty of care to its client where it has given advice even of a limited nature (as it then has a duty to make sure that the advice is correct). *Springwell* shows that it is much more difficult to prove that the bank had a duty to the client to give advice of its own volition (for example, to warn a client against investing in a particular product).⁵

In summary, in mis-selling claims, the court will look very carefully at the actual relationship between the parties in order to decide whether the bank had a duty to advise. Factors which may help support this include: (a) there was a written advisory agreement, rather than an "execution only" contract;⁶ (b) there was discussion of investment objectives; (c) the bank charged ongoing fees for advisory services; and (d) the contract did not include a clause that the investor was making its own decisions rather than relying on the bank.

3. Making a misrepresentation claim against the bank

Even if an investor cannot prove that the bank had a duty to advise him, he may be able to prove that the bank misrepresented the nature of the investments. If the investor can show that inaccurate statements were made by the salesman, there may be liability for misrepresentation.

4. Bank exclusion clauses

In complex financial transactions, it is common that the contract includes "non-reliance" clauses. Here the investor states that the bank has not given any representations, warranties or undertakings. He will also often say that he is not entering into the contract as a result of, and does not rely on, any representations by the bank. These clauses are often in facilities agreements; prime brokerage agreements; subscription agreements; swap documentation; term sheets; and marketing materials.

In *Springwell*, the clauses were that: Springwell had made its own investment decisions; the bank had not made any representations to Springwell; and Springwell had not relied on anything that the bank may have stated. The court decided that parties could agree what they like and that an investor can agree something as the basis of the contract even if both parties know that it is not the case.⁷ So, the investor, Springwell, was contractually prevented (estopped) from arguing that the bank had made representations which it could use to make a claim against the bank.

The precise wording and scope of the clauses will be vital, however: In some cases they may not be wide enough to protect the bank. For example, in the recent case of *Axa Sun Life Services plc v Campbell Martin Ltd*,⁸ the Court of Appeal said that if a party wants to exclude liability for misrepresentation then this must be clearly stated. If the clause simply says that the contract under which the claim is made supersedes any agreement previously made, this "will not by

⁴ *Bankers Trust International Plc v Dharmala Sakti Sejahtera* [1996] CLC 518/

⁵ In *Camarata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm), the defendant made a contract to provide an investment advisory service to the claimant. It was held that the defendant did not have a duty to offer advice beyond that which had been contemplated by the agreement; the claimant had not specifically asked whether the note was safe from the risk of counterparty default; the defendant gave his own view/impression that investments would be safe, but he did not provide more specific or firmer advice or assurances.

⁶ See, eg, *Wilson v MF Global UK Limited* [2011] EWHC 138 (QB), in which the accounts were opened on an "execution only" basis and the court held that there was no duty to give advice. See also *Bank Leumi (UK) Plc v Wachner* [2011] EWHC 656 (Comm).

⁷ *Springwell (Court of Appeal)* at paragraphs 143 and 156. In making that finding, Aikens J relied on authorities such as *Peekay Intermark Ltd v ANZ Banking Group Ltd* [2006] 2 Lloyd's Rep 511. See also *Camarata Property Inc v Credit Suisse Securities (Europe) Ltd* [2011] EWHC 479 (Comm); and *Standard Chartered Bank v Ceylon Petroleum Corp* [2011] EWHC 1785 (Comm) in relation to contractual estoppel.

⁸ [2011]EWCA Civ 133.

itself absolve a party of misrepresentation where its ingredients can be proved".⁹

5. Escaping bank exclusion clauses

If a bank relies on exclusion or "non-reliance" clauses, an investor may be able to argue that section 3 of the Misrepresentation Act 1967 ("the 1967 Act") applies. Under that section, if the clause excludes or restricts a party's liability for misrepresentation, it will be ineffective unless it satisfies the "reasonableness" requirement that is set out in section 11 of the Unfair Contract Terms Act 1977 ("UCTA"). To satisfy that requirement, the clause must have been a "fair and reasonable" one to be included, having regard to the circumstances at the time when the contract was made.

In *Springwell*, the Court of Appeal was satisfied that certain provisions did amount to exclusion (or exemption) clauses for the purposes of section 3 of the 1967 Act.¹⁰ This may be encouraging for investors making claims even though the Court decided that on the particular facts of the *Springwell* case the clause was reasonable partly because the case involved "a particular sophisticated investor in emerging market investments who was conscious of the risks".¹¹

The other way in which to escape exclusion clauses is to allege that the bank has been fraudulent. Fraud may be difficult to prove and there must be strong evidence to support the allegation. The investor must establish the absence of an honest belief by the bank in the truth of what it has stated.¹² Fraud will be proven if it is shown that a false representation has been made knowingly, or without belief in its truth, or recklessly (that is, careless whether it is true or false).¹³ It will be sufficient if the bank *suspected* that its statement might be inaccurate.¹⁴

6. Regulatory claims against banks

Under section 150 of the Financial Services and Markets Act 2000 ("FSMA"), a "private person" may bring a claim against a bank (provided that the bank is an "authorised person" under FSMA - most banks are) if the bank has contravened FSMA and this has caused loss to the claimant. A "private person" is an individual¹⁵ (the claim can also, in rare cases, be by a company if it can prove that the loss was suffered in circumstances where it was not carrying on business.)¹⁶

Banks and other institutions that are regulated by the Financial Services Authority ("the FSA") must comply with the FSA's Conduct of Business Sourcebook ("COBS"). This implements core components of the EU's Markets in Financial Instruments Directive (MIFID). If the bank fails to comply

⁹ Ibid at paragraph 94. See also *BSkyB Ltd v HP Enterprise Services UK Ltd* [2010] EWHC 86 (TCC).

¹⁰ In this context, the Court referred (at paragraphs 180-181) to *Raiffeisen Zentralbank Osterreich AG v Royal Bank of Scotland plc* [2010] EWHC 1392 (Comm): parties may not "retrospectively ... alter the character and effect of what has gone before" and, in so doing, exclude liability. Note that some of the provisions were *not* exclusion clauses because they simply set out how Chase was agreeing to contract with *Springwell*.

¹¹ *Springwell* (CA) at paragraph 183. In *Raiffeisen*, the clause was held to be reasonable because (amongst other factors): both parties were large commercial entities; the transactions were at arm's length; RZB had experience of the particular market; and the clause was in a form that was regularly used in the market. Again, investors may seek to show that their own position is different.

¹² *Derry v Peek* (1889) 14 App Cas 337. Alternatively, there must be knowledge that a fact stated previously is no longer true: *Fitzroy Robinson Ltd v Mentmore Towers Ltd* [2009] EWHC 1552 (TCC).

¹³ *Derry v Peek* (1889) 14 App Cas 337, 379.

¹⁴ Although, in *Cassa di Risparmio della Repubblica di San Marino SpA v Barclays Bank Ltd* [2011] EWHC 484 (Comm), the claim in fraud failed, each case will depend on its own facts.

¹⁵ Unless they suffered the loss while carrying on a "regulated activity" under FSMA.

¹⁶ See *Titan Steel wheels Ltd v Royal Bank of Scotland plc* [2010] 2 Lloyd's Rep 92.

with COBS, a private person can bring court proceedings against it under section 150. COBS has wide effect and applies to certain activities that are carried out by a bank from the UK — even if the investors are abroad.¹⁷

COBS 2.1 may be relevant: a firm must act "honestly, fairly and professionally in accordance with the best interests of its client". Firms must also provide sufficient information when dealing in derivatives — especially as regards risks (COBS 2.2).

The bank's classification of its customer will be important.¹⁸ Under COBS, there is a distinction between "retail" clients, "professional" clients and "eligible counterparties". "Retail" clients are given the most protection.¹⁹ A bank can categorise a customer as a professional client if the bank complies with certain conditions, including assessing the client's experience level; ensuring that the client states in writing that it wishes to be treated as a professional client; and the bank warns the client of the protections that he may lose. Investors who are considering bringing claims against a bank should check whether the bank followed these procedures.

Investors may also have a claim against a bank for a contravention of COBS 4, 9 or 10:

- (a) COBS 4, a firm must ensure that a communication or financial promotion is fair, clear and not misleading, and it must properly indicate any risks.
- (b) COBS 9, if a firm makes a personal recommendation, it must confirm that it is suitable for the client, by obtaining certain information (for example, experience levels) from the client.
- (c) COBS 10, if a firm provides investment services, it must ensure that the services are appropriate for the client, although it may not need to do so if the services are "execution only" (ie, non-advisory). As indicated above, investors should check whether their agreements are advisory or "execution only".

7. Municipalities' interest rate swaps

There has been a significant amount of litigation about interest rate swaps made by public authorities. There have been cases involving Norwegian and German authorities, and numerous claims which involve Italian public authorities are in progress and are of importance.

From 2001 to 2008, hundreds of Italian public authorities entered into interest rate swaps. Those transactions were made under the ISDA Master Agreement (International Swaps and Derivatives), and they were often governed by English law and contained English jurisdiction clauses. That meant that disputes relating to those swaps are likely to be dealt with by the English courts, unless the public authorities start 'pre-emptive' litigation in Italy.

So far, only one case in relation to the Italian swaps has reached a trial in England: the remainder are still en route to trial. The case is *Depfa Bank plc v Provincia di Pisa*,²⁰ which dealt with questions of jurisdiction. The background was that the Province of Pisa entered into bonds and connected interest

¹⁷ There are various territoriality requirements, which are set out in COBS.

¹⁸ See *Bank Leumi (UK) Plc v Wachner* [2011] EWHC 656 (Comm) and *Wilson v MF Global UK Limited* [2011] EWHC 138 (Q8).

¹⁹ A "retail" client is a client which is not a "professional client" or an "eligible counterparty" (COBS 3.4.1). COBS 3.5 defines professional clients; these include, for example, entities that are regulated to operate in the financial markets. If individuals conduct their business via a company vehicle, that company may be characterized as a "professional" client. COBS 3.6 defines eligible counterparties — these include investment firms, credit institutions and insurance companies.

²⁰ [2010] EWHC 1148 (Comm).

rate swaps with Depfa Bank and Dexia Bank. Interest rates collapsed, and Pisa owed the banks substantial sums under the swaps. Pisa alleged that the banks had represented that the transactions would produce a saving, but that in fact there were hidden costs, and that therefore Pisa could treat the transactions as invalid.

The banks commenced an action in the English court, and Pisa contested the English court's jurisdiction to hear the dispute. It did so on the basis of article 22 of the Brussels Regulation on jurisdiction: it argued that the case involved a decision by the Court on the "validity of the decisions" of certain municipalities; and it alleged that Pisa did not have capacity to enter the swaps. The Court decided that the "validity of the decisions" of Pisa was only one issue and that the Court would also need to consider other important issues including arguments relating to mis-selling. Therefore, the English court had jurisdiction to hear the case.²¹

8. Conclusion

Following the financial crisis, numerous claims by investors, especially in relation to derivatives, have been brought against financial institutions, frequently alleging mis-selling. Because of decisions such as *Springwell*, it may not be straightforward to establish that a bank owed a duty to advise. However, this will depend on the facts of the particular transaction, and especially the level of sophistication and understanding of the investor.

There is also the possibility of making a claim in misrepresentation. Although the principle of contractual estoppel may make claims more difficult, investors are likely to challenge the precise scope and wording of any exclusion clauses and in appropriate cases investors will be able to use the 1967 Misrepresentation Act and UCTA against banks to try to escape exclusion clauses. In particular circumstances, investors may be able to allege fraud, to escape exclusion clauses, if they have strong evidence to support the allegation.

The regulatory regime may also assist investors: the COBS provisions may be relevant, and client classification is key — if the bank has incorrectly categorized the client, a claim against the bank may succeed.

Litigation over interest rate swaps continues to develop. Ultimately, while the English courts have shown some resistance towards upholding mis-selling claims (see cases above), there are also strong arguments that investors may raise in litigation.

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²¹ Subsequent to Hamblen J's decision, Pisa did not raise additional arguments, relating to an alleged breach of certain Italian regulations. It should also be noted that in a recent Italian decision, the court found that several swaps which *had* been entered into by the Municipality of Rimini were void because the ISDA had not been signed by the bank (see FT, "Unicredit municipal deal nullified" (Financial Times 22 Oct 2010)). Alongside these cases, Italian criminal prosecutors have been investigating certain investments banks which entered swaps with the Municipality of Milan: misrepresentations have been alleged.