Feature

KEY POINTS

- The financial regulatory regime is intended to facilitate a co-operative model of contracting. English common law starts from the opposite, competitive, premise.
- The FCA's review of the mis-selling of hedging products by the banks excluded more than a third of the products sold, "sophisticated" SMEs being left to their remedy at law. The FCA's scheme is subject to appeal to the Court of Appeal.
- The common law in relation to rate derivatives mis-selling to SMEs is uncertain, dominated by "contractual estoppel", the jurisprudential basis for which remains to be authoritatively explained, and first instance judgments of doubtful authority. The present unsatisfactory position should be a matter of public concern.

Author Paul Marshall

Travels in unreality:[1] hard cases for SMEs and the making of English financial law

In this article, Paul Marshall analyses the present unsatisfactory state of English law on swaps mis-selling.

> 'Humankind cannot bear very much reality.'
>
> – TS Eliot, Burnt Norton

INTRODUCTION

Adam Smith, in *The Theory of Moral Sentiments* (1759), advanced the thesis that capitalism works best when there subsists between market participants a high level of trust. Where that trust diminishes, costs are increased. The financial crisis was the result of abandonment of conventional prudential lending and a Gadarene drive for profit. UK retail banks as a result forfeited public trust, a trust in many instances the product of long, hitherto carefully nurtured, relationships on which they traded.[2] The stand-out UK example, The Royal Bank of Scotland under the direction of (formerly) Sir Fred Goodwin, though frequently held up as a model by Harvard Business School, singlehandedly almost brought down the entire UK economy.[3] Regulatory failure by the Financial Services Authority[4] played a part, subsequently acknowledged by its own internal inquiry that Parliament demanded be made public.[5] To this day the banking sector remains both to a significant extent state owned, but also on life-support, an important patient accorded every consideration.

Small and medium sized enterprises (SMEs) form a large and vital part of the UK economy. According to official statistics, SMEs account for 60% of all private sector employment and registered an annual turnover of £1.6trn at the start of 2014, that is to say, about 47% of the then private sector total. High-growth small enterprises are vital to the economy and create a disproportionate number of new jobs.[6]

The massive destructive consequences visited upon the UK entrepreneurial SME economy, an economy particularly dependent on debt finance, have been largely incapable of legal formulation on a principled basis so as to support a satisfactory remedy at law for the businesses affected. The result for many businesses harmed, and often destroyed,[7] by complex derivatives sold to them by banks, is that that loss is commonly uncompensated and uncompensatable in the face of unsatisfactory first instance judicial decisions. This has consequences for confidence, both for banks and for the courts. It ought to be a matter of public concern that harm caused to a significant section of the productive economy should go un-remedied. In a predictable and understandable desire to promote certainty, and a somewhat Canute-like attempt to avoid the further fragmentation of contract law in relation to banking, and perhaps also for less transparent but important reasons of domestic policy, both the courts and English financial services law have signally failed SMEs.

The failure is on the part of the bar as much as the bench, because as Milsom said, '[t]he common law itself is to surprising degree anonymous, largely because the intellectual initiative has come from the bar, rather than the bench and has been directed to the single case rather than to the state of the law. In the single case the difficulty has always been to escape from the past, and there has been little opportunity to look to the future. Only where events or a bold hand had produced a clean slate, as with the mercantile work of Holt and Mansfield, could individuals in some sense mould the law."[8]

The problem is exacerbated by the fact that an interest rate swap can be sold integral to a fixed-rate loan contract (commonly, a "Tailored Business Loan" (TBL)). The prevailing view is that, because a contract for a loan is not itself a "contract for differences", a derivative hedging product embedded in a loan is outside the regulatory regime, despite it operating in precisely the same way as a regulated product and carrying materially similar counterparty risks. About 40,000 regulated products were identified as having been sold as OTC regulated trades to retail customers at the time the FCA concluded its review of the mis-selling of regulated interest swaps.[9] By that time the FCA had identified 60,000 transactions involving (unregulated) TBLs sold by five banks.[10] The FCA has expressed its view that TBLs should be regulated.[11] The Treasury Committee recorded that 'banks have expressed concerns about the consequences of widening the regulatory perimeter'. RBS, adopting the position of turkeys at Christmas, questioned whether 'extending the perimeter of regulation to include commercial lending would help the supply of finance to SMEs' because doing so would 'increase the operating costs'.[12]

Explanations for the current unsatisfactory state of the law are interlinked, making the problem intractable. These include:

(i) a dominant judicial philosophy preferencing a competitive self-reliant model of contract law, perceived as good for UK hidden exports, but in the context of OTC sales of derivatives to unsophisticated SMEs arguably inapposite and anachronistic;
(ii) judicial anxiety about contaminating English contract law with foreign/Continental notions of fair dealing and good faith;
(iii) insufficient regard being paid to the substantive, as distinct from merely formal, requirements of consent, where the signature rule in *L'Estrange v Graucob*[13] occasionally serves as a kind of judicial comfort blanket obviating further analysis;
(iv) related to this, perhaps an insufficiently rigorous analysis of the question of whether or not "basis clauses" are to be treated as exemption clauses and too ready acceptance that these represent a genuine agreement defining the scope of parties' obligations, rather than the exclusion of liability for their breach; and
(v) a (not unconnected) judicial temptation to be over-confident of commercial judgment where judges rarely have any direct personal commercial experience, as Lord Neuberger has observed.[14]

The upshot is that English courts uphold agreements where, to paraphrase Lord Reid in *Suisse Atlantique*,[15] the unsophisticated purchaser of a derivative may not have had time to read the bank's standard terms.[16] If the terms were to have been read without expert assistance these would probably not have been understood by the customer (and sometimes *could not* have been understood[17]). If the terms were understood and objected to, the position would be "take it or leave it", and if the counterparty went for a similar product to a different bank the result would be the same.[18]

Freedom of contract surely implies some choice or room for bargaining.[19] Myths can be multiplied by a presumption that the terms putatively accepted by signature reflect a negotiable, if not negotiated, allocation of risk, and an adjustment in price.

THE PROBLEM IN A LITTLE MORE DETAIL

One purpose of the complex and careful statutory regulatory regime for the sale of financial investment products, given effect to by the Financial Services and Markets Act 2000 (FSMA), by the FCA under the elaborate Conduct of Business Sourcebook (COBS) rules that implemented MiFID I (Markets in Financial Instruments Directive I) and the obligations that these impose upon an "authorised person", is to confer a right of protection upon vulnerable counterparties. The greatest protection is afforded to those now classified as a "retail client", regardless of whether they be a real or abstract legal person. But where a contracting party to a derivative mis-sold by a bank has the misfortune to be a corporate, rather than natural, person engaged in business of any kind, the regulatory regime is reduced to mere lines on paper, an unenforceable aspiration.[20]

In addition to companies engaged in business being held to be intended by Parliament[21] to be excluded from the statutory right of action provided for loss occasioned by breach of the regulatory rules that exist for their protection, the present judicial perception is that vulnerable corporate counterparties, in agreeing to "basis clauses", routinely contract out of and surrender protections otherwise available at common law. Where a misrepresentation has been made or advice given, such terms may record that no representation has been made and no advice given, even where known to be untrue. A party is said to be "estopped[22] by contract" from asserting the position and claiming damages in reliance upon the true facts. The view, *sub silentio*, is that parties only have themselves to blame for agreeing to such terms ('more fool them') and that it is no responsibility of the courts to protect a person from their own foolishness. The position is reinforced by decisions holding that "basis clauses" lie outside the statutory protections provided by the Misrepresentation Act 1967 and Unfair Contract Terms Act 1977 (UCTA). This rather muscular kind of individualism would have been recognisable in Victorian England. It is decidedly dissonant with the development of European and domestic financial law since 1986, particularly in the context of MiFID I that requires a co-operative model of contracting. Further, as Professor Richard Hooley has suggested, 'there remains something unsettling about a world that parts company with reality and where business is done on the basis of knowingly untruthful statements contained in the contract itself'.[23] If a triumph of form over substance, basis clauses have the merit of contractual certainty.

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otherwise required to do so, starts from the premise that the purchaser must look after himself. The concept of "good faith", outside special categories of contract, provokes an almost allergic response among English judges, save in bold and rare instances.[24] Financial regulatory law starts from the opposite premise. The third regulatory objective of MiFID I, implemented in 2007 under the FCA's rules, is the protection of consumers. The FCA requires this policy objective to be implemented by regulated entities in "treating customers fairly" (TCF).[25] In broad terms this requires having regard to a customer's interests/needs. But a hard-edged boundary between the common law and financial regulatory law was emphasised by the Court of Appeal in *Green & Rowley v RBS*.[26] Unless expressly provided for by contract, at common law a bank or other regulated person owes no duty of care in negligence to bring home to a purchaser of a swap the potential scale of a break-cost risk to which they are exposed by early termination of a derivative contract, given certain hypothetical assumptions about market conditions. An important issue not considered in the appeal was Judge Waksman QC's view that the break costs of an interest rate derivative were merely "ancillary" to a swap transaction and their contingent dimension, as distinct from general risk, did not require to be adverted to to satisfy the regulatory requirements. Having been given permission to intervene in the appeal, the FCA in written submissions to the Court of Appeal disagreed, expressing its view that a party could not understand the nature of the risk of a break cost without knowledge of its prospective dimension.

The issue of explanation of the risks associated with the contingent dimension of break costs arose again, this time in a common law context, in *Crestsign v NatWest* and *RBS*.[27] A claim independent of an advisory duty (held precluded by a basis clause) was made on the basis of the duty of care owed under the principle in *Cornish v Midland Bank*[28] (restated in *Bankers Trust v Dharmala*[29]) that, once an explanation is volunteered, such explanation is required to be full and accurate, including as to risks associated with the product. The risk warning provided by the bank in *Crestsign* was in generalised terms and merely provided: 'Please note that such break costs may be substantial.' The deputy judge concluded '… that the banks gave just enough information to avoid a breach' of duty. In doing so he rejected any requirement on the part of the bank to volunteer information about the contingent dimension of potential break costs 'in the absence of … an enquiry being made of them'. But banks themselves routinely carefully model those costs and risks in connection with their own counterparty default exposure. In giving permission to Crestsign to appeal, Sir Colin Rimer, on a renewed oral hearing (the right to which has recently been abolished), concluded that (among other issues) the challenge to the correctness of the deputy judge's reasoning on the adequacy of the bank's disclosure of risk had a real prospect of success. That appeal was compromised by RBS before the appeal could be heard, on terms, it is to be inferred, satisfactory to Crestsign.

There are two overarching considerations to any commercial transaction: on the one hand certainty as to obligation and enforcement; on the other calculability (exposure). Treating break costs as "ancillary", rather than as fundamental, subverts the commercial objective of calculability.

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That this is so is illustrated by the recent decision in *Finch v Lloyds TSB Bank plc*[30] that concerned a TBL. When the company came to repay the loan, it discovered the clause that required the break cost of the swap to be paid. The unexpected cost was £1.5m that the company could not afford. It went into administration. The judge held that Lloyds was under no duty to explain the nature of the risk for to do so was contrary to the bank's own interests. While this is a conventional *Walford v Miles* competitive "freedom of contract" analysis, the wider problem of the exchange of risk (fundamental to the transaction) that a counterparty has no means of evaluating and for practical purposes is *incapable of evaluating*, perforce remains unconsidered.

Doctrines and principles that part company with, or perhaps, better, are unable to accommodate, reality (in this context how unsophisticated SMEs *in fact* contract with banks) carry risk regardless of how laudable their object. A bank that succeeds in recovering substantial break costs for an interest-rate derivative, the fact or dimension of which was unknown and unevaluated by the counterparty, will typically destroy the prospect of a continuing banking relationship. Where this effect becomes widespread it erodes confidence in banks as such. Where this happens in a generalised way, not only does this carry reputational risk for banking institutions, but there is risk to the reputation of contract law itself.

RIGHTS WITHOUT REMEDIES

The purpose of the regulatory rules was considered by the Court of Appeal in *Rubenstein v HSBC Bank plc*[31] and described by Lord Justice Rix as imposing: 'onerous duties … designed to ensure that the investment adviser understands his client and his client understands risk'. The trial judge had concluded that the bank's salesman 'understood neither the client he was advising, nor the product he was recommending. He did not even understand that he was advising, as distinct from merely executing his client's instructions.'

The regulatory rules and their object, as enhanced and augmented by MiFID I, were widely disregarded by banks. From November 2007 post-MiFID business was conducted much as before. In 2012 the FSA announced that it had found serious regulatory failings by retail banks in the sale of hedging products to businesses to manage their interest rates. The principal findings (in over 80% of transactions) were: (i) a failure to properly disclose exit costs; (ii) a failure to ascertain customers' understanding of risk; (iii) advised sales being incorrectly classified by banks as non-advised sales; (iv) "overhedging"; and (v) rewards and incentives as a driver for all these practices. To avoid the public furore ensuing from the PPI mis-selling fiasco, the FSA announced that a voluntary redress exercise would be undertaken by agreement with nine retail banks for the purpose of delivering a fair and reasonable outcome for their customers. But more than 10,000 SME businesses, otherwise eligible, were excluded from the review on grounds that they were deemed by the FSA to be "sophisticated". The definition of sophistication that the FSA came up with, in a private (originally undisclosed) agreement with the banks participating in the review, was that a business with a turnover exceeding £6.5m *net*, together with either a balance sheet of more than £3.26m or more than 50 employees would be deemed "sophisticated".

By late amendment to the agreement, it was further agreed that customers should be deemed "sophisticated" if the aggregate value of "live" interest rate hedging products (IRHPs) exceeded £10m. Put another way, the greater the risk carried by the investment product, and thus exposure, the more sophisticated the client was deemed to be. (It seems that the FSA saw nothing objectionable about this.) The adopted definition of "sophistication" does not correspond with any legal definition of sophistication. It excluded more than a third of customers, otherwise eligible, from the review population. In 2015, it was accepted by the FCA (as it by then had become) that the excluded third were likely to exceed a third in value of mis-sold products, typically the larger customers.[32] They were also much more likely to be corporate persons. In short, the largest mis-selling claims, most likely to be made by companies, were agreed between the FCA and the banks to be excluded from the review and left to such remedy as they might have at law.

As already noted, corporate SMEs have been held to be excluded from the statutory right of action under s 138D of FSMA and the Financial Services and Markets Act 2000 (Rights of Action) Regulations 2001 that provide a remedy in damages for breaches of the regulatory rules where causative of loss. In *Titan Steel Wheels Ltd v Royal Bank of Scotland plc*,[33] David Steel J held that a corporate buyer of a regulated financial product purchased in the course of carrying on a business has no statutory right of action under FSMA because, in his judgment, such a person is not within the statutory definition where a regulated product is purchased 'in the course of carrying on a business of any kind'.[34] So companies cannot sue for breaches of rules intended by statute to protect "private persons", a designation not to be found in MiFID I. That applies just as much to a single director family-run business without internal financial expertise as it does to a public company.

The Court of Appeal gave permission to challenge the correctness of the decision in *Titan Steel Wheels* in *MTR Bailey Ltd v Barclays Bank plc*[35] where MTRB's claims were comprehensively, and somewhat testily, dismissed by the judge. Permission to appeal was granted on a renewed oral application to the Court of Appeal following refusal on paper (a right now abolished). In giving permission to appeal, Lord Justice Kitchin said: '[MTRB] submits that both [*Titan Steel* and *Camerata*] were wrongly decided and that their effect is to rob [the statutory claim] of its substance because most companies will be in business of some kind. He has persuaded me that this issue does merit consideration by this court and it is one upon which the Company has a real prospect of success.' The appeal was compromised by Barclays before it could be heard.

The argument remains available, but only to a party with appetite, and more importantly resources, to pursue a claim to appellate level. In the seminal United States' Federal decision in *Marbury v Madison*[36] Chief Justice Marshall observed that the 'very essence of civil liberty certainly consists in the right of every individual to claim the protection of the laws whenever he receives an injury', adding that a government cannot be called a 'government of laws, and not of men … if the laws furnish no remedy for the violation of a vested legal right'.

UNREAL ASSUMPTIONS

English courts have always been reluctant to find a bank liable for giving negligent advice.[37] This has important consequences for international banks in their frequently choosing English law and jurisdiction.[38] The reluctance is informed by an historic view of the core characteristic of the bank–customer relationship being the holding of the money on deposit.[39] However, even as recently as in 1959, some judges[40] noted that the business of banking had changed and that banks might in certain circumstances assume an advisory role.[41] Nonetheless, where a dispute concerns the sale of heavily regulated complex financial products, the starting point for judicial analysis is commonly the "conventional bank–customer relationship", as though, as such, capable of shedding light upon the actual obligations assumed by the parties in the particular circumstances.

Current institutional resistance of the courts to claims that banks assume an advisory role is often said to find support in the decision of Mrs Justice Gloster in *Springwell Steam Navigation v JP Morgan Chase Bank and Ors*.[42] Stripped of nuance, the relevant proposition is that, ordinarily, the absence of express agreement or payment for advice are factors that weigh heavily against a bank having assumed an advisory role. A further proposition said to be derived from *Springwell*, that has assumed curious weight, is that a salesman, *by virtue of being a salesman*, is unlikely to assume an advisory role, and that care must be taken in distinguishing between the *roles* of adviser and salesman. In *Thornbridge v Barclays Bank plc*,[43] in dismissing the claim, Judge Moulder relied heavily on this supposed dichotomy, in doing so perhaps falling into the analytical error of identifying duties by role, an error exposed by Millett J in *Bristol & West Building Society v Motthew*.[44] This kind of approach no doubt has attractions, but it is rare to see reference made either to the unusual circumstances of the dispute in *Springwell* or to Gloster J's carefully nuanced words.

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The facts in *Springwell* are about as far removed from the one-off OTC sale of an IRHP to a MiFID/COBS "retail client" as can be conceived of. Springwell was the investment vehicle for a group of family-owned Greek shipping companies. There was a long-established relationship with J P Morgan Chase. From the 1990s Springwell began investing heavily in emerging market debt. By 1998, it had a leveraged portfolio of instruments with a face value of US$700m concentrated in Russian debt securities known as "GKO-linked notes" issued by Chase and traded in US dollars. The notes contained embedded forward currency swaps to remove the rouble–US dollar currency risk. In August 1998, the Russian government declared a moratorium on foreign debt repayments and suspension of trading on Russian Federation issued bonds that affected the notes. At the time Springwell had 11 notes in its portfolio. It sued for its losses claiming, among other things, an advisory relationship and that no reasonable advisor could have advised investing in the GKO linked-notes.

Gloster J anchored her judgment in a detailed analysis of the actual relationship that subsisted and the nature of the transactions in question, observing:

> 'Although it was common ground that at the relevant time there was no regulatory obligation upon Chase to record the terms of any investment advisory agreement, or advisory obligation, in writing (at least in relation to a client such as Springwell), the absence of any written agreement recording such a relationship, between substantial commercial parties, where the investment activity involved complicated transactions, involving huge amounts of money over many years, is surprising (to say the least), if indeed such a relationship existed.'[45]

These words have no obvious application to a bank's sales team subject to performance targets with bonus incentives that has sought to conclude a one-off sale of a hedging product to a financially unsophisticated retail client anxious about its interest rate exposure under a loan facility.

Further, the distinction between the provision of information and advice is notoriously easier to state, especially by judges and lawyers, than to identify in practice.[46] This truth is recognised by Art 19 of MiFID I, introduced in recognition of the widespread problem identified by the European Commission that advised sales of investment products were frequently mis-classified as non-advised "execution-only" sales. Article 19 effectively abolished execution-only sales for interest rate derivatives under what amounts to a statutory presumption against them,[47] though this appears perhaps to have been lost sight of in *Thornbridge*.[48]

In *Crestsign*, the banks defended the claim on the basis that the transaction was not an advised sale. The deputy judge said of the salesman:

> 'I accept that [Mr Gillard] may not have appreciated that he was in substance giving advice in the meeting, the telephone conversations and his two emails, and that he probably believed when giving his evidence at the trial that he had not done so, but that does not alter my conclusion to the contrary…'

In circumstances such as these, recourse to generalised propositions about the conventional bank–customer relationship, or to how salespersons conventionally behave, provide limited, if any, assistance. Not uncommonly, the distinction between advice and information is poorly understood by salespersons.[49]

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In *Thornbridge* Judge Moulder dismissed the claims finding that the salesman '*was very familiar with the distinction between execution only and advised transactions*' a distinction of which the judge also held the relationship manager to have been 'well aware'.

But, as noted, that distinction was for practical purposes abolished from November 2007 under the COBS rules, six months before the relevant transactions in May 2008, and to which there is not a single reference in the judgment.

A POSSIBLE WAY THROUGH

The doctrine of "contractual estoppel" was for the first time in 2006 articulated by Lord Justice Moore-Bick in *Peekay v Intermark Ltd v Australia and New Zealand Banking Group Ltd*:[50]

> '[t]here is no reason in principle why parties to a contract should not agree that a certain state of affairs should form the basis of the transaction, whether it be the case or not… Where parties express an agreement of that kind in a contractual document neither can subsequently deny the existence of the facts and matters upon which they have agreed, at least as far as concerns those aspects of their relationship to which the agreement was directed. The contract itself gave rise to an estoppel…'

Though originally considered by many not to be necessary for the decision, on appeal in *Springwell*[51] Lord Justice Aikens held that contractual estoppel was 'consistent with principle and authority'. In doing so, however, it has been necessary to get round the statement by Mr Justice Diplock in *Lowe v Lombank Ltd*:[52]

> 'To call [Clause 9(ii)] an agreement as well as an acknowledgment by the plaintiff cannot convert a statement as to past facts, known by both parties to be untrue, into a contractual obligation, which is essentially a promise by the promisor to the promisee that acts will be done in the future or that facts exist at the time of the promise or will exist in the future. To say that the hirer agrees that he has not done something in the past means no more than that the hirer, at the request of the owner, represents that he has not done that thing in the past. If intended by the hirer to be acted upon by the person to whom the representation is made, believed to be true by such person and acted upon by such person to his detriment, it can give rise to an estoppel: it cannot give rise to any positive contractual rights.'

In order to get over this (considerable) difficulty, given that Diplock J has a claim to being the greatest English contract lawyer of the twentieth century, the solution adopted has been to say either that the issue being considered was substantively different, or else that the observation was not necessary for the decision in *Lowe*. But the three judges who have considered *Lowe v Lombank* have not been in agreement[53] between them in their analysis of Diplock J's proposition. The profoundly unsatisfactory position is further highlighted by the observation by Mr Justice Andrew Smith in *Credit Suisse International v Sitchting Vestia Groep*[54] that 'mere representations do not … engage the principle of contractual estoppel'. There must be a contractual *obligation* for the estoppel to bite on. As Professor Hooley has explained,[55] the effect of *Peekay*, and with decisions that have affirmed it as stating the law, is that the distinction between a warranty as a contractual promise (as emphasised by Diplock J), and a representation as a statement of fact or law has been blurred:

> 'Is a statement as to past facts, known by both parties to be untrue, a mere representation or does it give rise to a contractual obligation? What is the nature of the breach of a basis clause relied on as giving rise to a contractual estoppel? Is such a clause capable of being interpreted in Lord Diplock's words as breach of a "primary obligation"[56] constituting a breach of contract? It remains to be authoritatively explained.'

This is highly unsatisfactory, but the only possibility of *Peekay* and the doctrine of "contractual estoppel" being overturned lies with the Supreme Court.

In *Crestsign* the judge dismissed the claim but nevertheless held that Crestsign had been mis-sold an interest rate derivative as an advised sale. Importantly, the judge also held that, were it to have application, which in his judgment it did not, the terms relied upon by RBS and NatWest would fail to satisfy the test of "reasonableness" under UCTA. In his judgment UCTA had no application because the duty to which *ex hypothesi* the test of "reasonableness" should apply did not arise by reason of the contract term itself. This is unfortunate, given that the regulatory rules explicitly prohibit a regulated person from relying upon a contract term excluding an obligation that otherwise exists under the rules (considered by the author in [2014] 11 JIBFL 679). The unsatisfactory result has yet to be considered because the appeal in *Crestsign* was compromised before heard.

There is an argument, yet to be had, that a more realistic co-operative analysis of financial contracts, where they exhibit wide disparities in expertise and bargaining strength, is warranted. In arguably one of the most important decisions in contract law of the twentieth century, Diplock LJ in *Hongkong Fir Shipping v Kawasaki Kisen Kaisha*[57] explained the limitation of classification of terms (the statutory condition/warranty distinction) in the abstract. The wholly innovative aspect of the decision was Diplock LJ's statement that the court was required to 'look at the events which had occurred as a result of the breach at the time at which the charterers purported to rescind the charterparty and to decide whether the occurrence of those events deprived the charterers of substantially the whole benefit which it was the common intention of the parties … that the charterers should obtain from the further performance of their own contractual obligations'. On one view, as Professor Roger Brownsword has observed,[58] *Hongkong Fir* can be interpreted as a decision that encourages a co-operative, rather than competitive, model of contractual analysis.[59] Further, at least since *Wickman Machine Tool Sales Ltd v L Schuler AG*[60] and *The Antaios Cia Naviere SA*,[61] where more than one interpretation of a provision is available, the court is enjoined to adopt an interpretation that accords with common and commercial sense and avoids very unreasonable results. There is no reason why this approach should not apply to the construction of "basis clauses"; indeed there is every reason why it should. Recently, the Supreme Court in *Arnold v Britton*[62] has said that objective interpretation of contractual obligations requires consideration of, among other things:

- the overall purpose of the clause;
- the facts and circumstances known, or assumed to be known, to the parties at the time the document was executed; and
- commercial common sense.

In approaching the question of whether it was the parties' (objective) intention to delineate their obligations or, rather to exclude or restrict liability, where there is a significant imbalance in experience, expertise and available information in connection with the exchange of risk, and thus disparity in bargaining position, the courts should perhaps be slower to interpret basis clauses, as objectively genuine agreements, circumscribing the scope of obligations assumed, rather than as exemption clauses.

In *Raiffeisen Zentralbank Bank Osterreich v RBS*,[63] Mr Justice Christopher Clarke explained that the key question in deciding whether a "no representation" or "no reliance" clause is an exemption clause (in which case, liable under s 3(1) of the Misrepresentation Act to be held to be of no effect unless satisfying the requirements of "reasonableness" under UCTA) is 'whether the clause attempts to rewrite history or parts company with reality'. Hooley has pointed out that this is immediately followed by an important but little-noticed footnote in the judgment (*fn* 45): 'As in *Lowe v Lombank* when the agreement was as to "past facts, known by both parties to be untrue".' Hooley suggests that Clarke J here '*implicitly accepts that there must be a balance between the "real" world of actual occurrence and the "virtual" world of contractual agreement, such that a known untruth may only be used by the contracting parties as the basis of their relationship when it is reasonable to do so*'. Hooley disagrees with Judge Moulder's analysis in *Thornbridge*, suggesting that there is confusion in the judge's analysis in eliding two separate issues: (i) (correctly) that the doctrine of contractual estoppel can apply to contractual statements about past facts known by the parties to be untrue; and (ii) the distinction to be drawn between definitional statements and those that are exclusionary for the purpose of determining whether they fall within s 3 of the Misrepresentation Act. He suggests that, contrary to Judge Moulder's reasoning, 'a clause may be binding at common law, under the doctrine of contractual estoppel, and yet still be categorized as exclusionary, so as to be unenforceable under the statute if it fails the test of reasonableness'.[64] Judge Moulder's decision is subject to appeal to the Court of Appeal.

CONCLUSION

At a high level of abstraction, one purpose of financial regulatory law is to level the playing field for the sale of complex products where there exists an imbalance of expertise and available information, and consequent unbalanced bargaining position. Regulatory law in the UK has substantially failed SMEs as the FSA 2012 review revealed. But the redress scheme set up by the FCA to fairly compensate victims of mis-selling excludes at least a third of the businesses affected and more than a third of products sold by value. At present these arrangements with the banks have been held not to have "sufficient public law flavour" to render these amendable to judicial review (*Holmcroft Properties Ltd v KPMG LLP*[65]) but the correctness of that conclusion is doubtful (*R v. Panel on Take-Overs and Mergers, ex parte Datafin*[66]) and is to be considered by the Court of Appeal in December 2017. Once excluded from the redress scheme operated by the FCA, a corporate SME can be reasonably confident that a common law claim against a bank for a mis-sold regulated derivative product, in the absence of documentary failure or fraud, will fail.

It is difficult to avoid the conclusion that, having been ruthlessly exploited by the banks, corporate SMEs have been failed by both the FCA and also by the courts. That the law is in disarray is evidenced by the fact that virtually all of the important first-instance decisions are, or have been, subject to appeals to the Court of Appeal[67] and several of the most important have been compromised leaving the legal position uncertain and incapable of resolution short of a party having both appetite and resources to appeal. Further, the right to appeal itself has recently been significantly cut back under the new rules of court which no longer provide a right to an oral renewal of an application to appeal refused on paper. Part of the problem is adherence of the common law in this area to a competitive model of contracting, as a kind of Darwinian zero-sum game, arguably antithetical to the promotion of trust between market participants. But that is an objective that the statutory regulatory regime, properly operating, is intended to facilitate by requiring a co-operative model of contracting with the purpose of facilitating transparency of risk.[68] The uncompromisingly hard-edged boundary between the common law and the regulatory system drawn by the Court of Appeal in *Green & Rowley* is unfortunate, but its wider implications were possibly unforeseen, for reasons that Milsom identified. Added to these difficulties and uncertainties is the strong inclination of judges to start from the premise that, in the absence of the clearest evidence, banks do not undertake an advisory role towards their clients. That premise is doubtful, as illustrated by the fact that those selling regulated products not infrequently are unable to identify the distinction between the giving of information and advice.[69] Questions arise as to why and how, from the beginning of this century, tens of thousands of interest rate derivatives came to be sold by banks to financially unsophisticated SME investors that hitherto had been managing perfectly well without them. The obvious answer is because they were recommended by banks to their clients, who hitherto had trusted their banks and their advice.

Erosion of confidence does not occur suddenly, but when it occurs its effects, as recently seen in other contexts, can be profoundly damaging. It would now require either a brave or foolish corporate SME to take at face value, and without a long spoon, any encouragement by a bank to invest in a complex regulated financial product. Given the obstacles to success, it also requires a brave corporate SME to seek redress from the courts for a mis-sold financial product. This position cannot be other than damaging to the UK economy for reasons long ago identified by Adam Smith. ■

1 Apologies to the late Umberto Eco – *Travels in Hyperreality*, Essays (1987).

2 Typically swaps have been marketed as "solutions", and see *Finch v Lloyds TSB Bank plc* [2016] EWHC 1236 (a TBL – below): 'The use of the phrase "*trusted advisor*" was simply a phrase adopted by the Bank and its employees as part of a marketing strategy to make the Bank appear different from its competitors' para [58].

3 Books to read are *Back From the Brink*, Alistair Darling (Atlantic Books, 2012), *Shredded*, Ian Fraser (Birlinn, 2014).

4 In part for this reason, since 1 April 2013 divided into (1) the Financial Conduct Authority (FCA) for market conduct (broadly consumer protection, integrity and effective competition) and (2) the Prudential Regulation Authority (PRA) overseen by the Bank of England.

5 Treasury Committee Fifth Report of Session 2012–13, The FSA's report into the failure of RBS, on 19 October 2012 published as House of Commons Paper No. 640.

6 Department for Business Innovation and Skills, *SMEs: The Key Enablers of Success and the Economic Rationale for Government Intervention*, December 2013.

7 See eg *Hockin v RBS* [2016] EWHC 925 (Ch) (interlocutory strike-out application) ultimately compromised within a few days of commencement of trial (2017), but only after years of litigation.

8 *Historical Foundations of the Common Law*, Oxford, 1981.

9 House of Commons Treasury Committee Conduct and Competition in SME Lending Eleventh Report of Session 2014–2015, 10 February at para 119.

10 Ibid.

11 Ibid, Q 701.

12 RBS evidence to Treasury Committee pp 56–57 para 142.

13 [1934] 2 KB 394.

14 'It does not seem obvious that a judge, who is normally fairly remote from business matters, would be particularly good at identifying the commercial common sense of any conclusion, let alone what a reasonable person might regard as commercially sensible.' Cited by Professor Neil Andrews

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[2017] CLJ 36, 55, fn 174, who put the point: 'Judges must not assume that they are masters of all trades, including "fishmongers and carriers of fish"' (fn 171 – Lord Bramwell).

15 *Suisse Atlantique Société d'Armement SA v NV Rotterdamasche Kolen Centrale* [1967] 1 AC 361.

16 eg, see *Crestsign* (fn 27): 'Crestsign was a retail client of the banks without, as I have already noted, any realistic prospect of timely access to adequate expert advice; and that Mr Gillard and Mr Flack [for the banks] knew Crestsign was under time pressure because of the deadline set by Northern Rock for refinancing without a penalty payment.'

17 Though in the slightly different context of a sale of an embedded swap, see *Finch v Lloyds* (fn 2) where the counterparty simply had no idea of the risk undertaken.

18 As the judge observed in *Thornbridge* (fn 43).

19 *Suisse Atlantique*, p 406 – an observation made in connection with the not unrelated issue of standard exemption terms.

20 Unless, exceptionally, there is an advisory relationship where the rules will inform the scope of the advisory duty: *Loosemore v Financial Concepts* [2001] Lloyd's Rep PN 235.

21 The intention is not that of Parliament because the definition was delegated to the Treasury under FSMA s 150 and is an executive decision given effect by subordinate legislation (cf. Lord Justice Tomlinson's comments in *Green & Rowley* [2013] EWCA Civ 1197).

22 There is in fact no doctrinal relationship with a true estoppel; contractual estoppel requires neither reliance nor detriment.

23 *Contractual estoppel and the Misrepresentation Act 1967*, University of Cambridge Legal Studies Research Paper 57/2016, para 59, www.law.cam.ac.uk/ssrn, a full appraisal and required reading for anyone interested in the issue. My debt to Richard Hooley's analysis in connection with s 3 of the Misrepresentation Act 1967 is gratefully acknowledged.

24 Notably, the judgment of Leggatt J in *Yam Sing Pte Ltd v International Trade Corp.* [2013] EWHC 111 QB (though good faith in performance rather than negotiation).

25 See, eg https://www.fca.org.uk/publication/archive/fsa-tcf-towards.pdf.

26 fn 21.

27 [2014] EWHC 3043 (Ch).

28 [1985] 3 All ER 513.

29 [1996] CLC 518 QBD.

30 fn 2.

31 *Rubenstein v HSBC Bank* [2013] PNLR 9 para [115].

32 Evidence of Martin Wheatley, CEO of the FCA, to the House of Commons Treasury Committee, Conduct and Competition in SME Lending, Loc cit.

33 [2010] EWHC 211 (Comm).

34 Followed by Flaux J in *Camerata v Credit Suisse Securities Europe* [2012] EWHC 7 (Comm).

35 [2014] EWHC 2882 QB, a decision criticised by the author in [2015] 1 JIBFL 11.

36 5 US 137 (1803) (the basis for US law on judicial review).

37 See, for example, the review by Greg Mitchell QC in [2014] 11 JIBFL 687.

38 A circumstance of considerable importance for UK invisible exports, as reflected in the recent establishment of the "Financial List" to attract "big-ticket"international litigation. This development has occurred at the same time that cost barriers to litigation for ordinary litigants have been dramatically increased. Just to initiate legal proceedings in the High Court for a claim for £1m now incurs a court fee (alone) of £10,000.

39 *Foley v Hill* (1848) 2 HL Case 28 QB.

40 eg Salmon J in *Woods v Martins Bank Ltd* [1959] 1 QB 55.

41 p 73.

42 [2008] EWHC 1186 (Comm).

43 [2015] EWHC 3430 (QB).

44 [1998] Ch 1.

45 Para [435].

46 eg *Walker v Inter-Allianz Group plc (in Administration) v Scottish Equitable plc* [2007] EWHC 1858, *Zaki v Credit Suisse (UK) Ltd* [2013] EWCA Civ 14.

47 Save subject to four stringent conditions – MiFID Art. 19(6).

48 MiFID Art 19(6) derivatives must now be evaluated either for "suitability" under an advised transaction (COBS 9) or, if not advised, their "appropriateness" (COBS 10).

49 eg *Rubenstein*, *Zaki*, *Walker*, *Crestsign*, loc cit.

50 [2006] EWCA Civ 386 para [96(ii)].

51 [2010] EWCA Civ 1221 (fn 42).

52 [1960] 1 WLR 196.

53 Aiken LJ at para [151] of *Springwell* did not agree with Gloster J's reason for distinguishing *Lowe* at first instance and also disagreed with Christopher Clarke J's analysis of *Lowe* in *Raiffeisen Zentral Bank Osterreich v RBS* [2010] EWHC 1392 (para [252]).

54 [2014] EWHC 3103 at para [303].

55 Loc. cit.

56 *Photo Production Ltd v Securicor Ltd* [1980] AC 827,849.

57 [1962] 2 QB 26.

58 *Landmark Cases in the Law of Contract*, Chapter 10 (Hart Publishing, 2008), eds. Charles Mitchell, Paul Mitchell.

59 *Hongkong Fir* was decided in the context of the collapse of freight prices at the time of the closure and unexpectedly early re-opening of the Suez Canal.

60 [1974] AC 235.

61 [1985] AC 191.

62 [2015] AC 1619 para [15].

63 [2010] EWHC 1392.

64 Loc cit. para [57].

65 [2016] 232 (Admin).

66 [1987] QB 815.

67 Including now *Property Alliance Group Ltd v RBS* [2016] 3342 (Ch).

68 Rix LJ in *Rubenstein*, loc. cit.

69 fn 49 above.

Further Reading:

- Humpty Dumpty is broken: "unsuitable" and "inappropriate" swaps tranlsactions [2014] 11 JIBFL 679.
- The big picture about the small print: why the courts' approach is unreal [2016] 11 JIBFL 649.
- LexisPSL: Banking & Finance practice note: Mis-selling interest rate hedging products – a guide for R&I lawyers.