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WHEN IS A BANK LIABLE FOR THE CONSEQUENCES OF ITS CUSTOMER'S FRAUD?

(1) Jeremy D Stone Consultants Ltd & (2) Jeremy Stone v (1) National Westminster Bank plc & (2) Paul Aplin

[2013] EWHC 208 (Ch)

Sales J

SUMMARY

The claimants failed in their attempt to obtain damages, equitable compensation or restitution from the defendant bank and its employee for losses suffered in connection with a fraudulent Ponzi scheme carried on by the bank's customer through accounts held with the bank.

In order to succeed in such a claim, the claimants needed to show that the bank (through its employee) knew of the fraud or turned a blind eye to it. The Judge found that this allegation was not made out on the facts and all claims against the bank and its employee were dismissed.

FACTS

Mr Jeremy Stone ("Mr Stone") made a considerable amount of money as a result of his employment and part ownership of a hedge fund investment company. He subsequently used this money to make a series of investments personally or through the First Claimant ("JDSCL").

One such investment involved an old family friend ("Mr Saunders") and his company, Saunders Electrical Wholesale Limited ("SEWL"). Mr Saunders told Mr Stone that SEWL had a very successful business supplying large quantities of electrical goods and other related goods to large, reputable hotel groups (including Hilton Hotels, Holiday Inn, Park Plaza and Radisson) (the "Hotel Business"). Mr Saunders asked Mr Stone to invest increasingly large sums in the Hotel Business and he did so between June 2009 and April 2010.

The Hotel Business was a fiction. In actual fact, Mr Saunders was using SEWL to run a large-scale Ponzi scheme (the "Scheme") and Mr Stone's money was used to keep the Scheme going. The Claimants did not find out about this until 28 April 2010 and by this time, it was too late for them to recover the outstanding amounts they had invested from SEWL or Mr Saunders. Mr Stone was left with very substantial losses.

Throughout this period, SEWL held several bank accounts with the First Defendant ("NatWest") and from December 2008, the Second Defendant ("Mr Aplin") was the relationship manager in charge of the relevant accounts. The Scheme was run (in part at least) through accounts held by NatWest in the name of SEWL, managed by Mr Aplin.

The Claimants alleged that NatWest (through Mr Aplin) knew about the Scheme or turned a blind eye to it and that Mr Aplin knowingly misled the Claimants about Mr Saunders' use of the relevant accounts. The Claimants therefore commenced proceedings against NatWest and Mr Aplin alleging:

(i) damages for the tort of deceit;
(ii) equitable compensation for dishonest assistance by Mr Aplin in a breach of fiduciary duty by Mr Saunders;
(iii) damages for conspiracy by Mr Aplin with Mr Saunders to injure the Claimants;
(iv) unjust enrichment of NatWest by its receipt of money paid into the SEWL accounts by mistake; and
(v) damages for Mr Aplin's negligence, the Defendants denied all of these claims.

HELD

Sales J rejected all of the claims against both Defendants for the following reasons:

Deceit, dishonest assistance and conspiracy

Each of these claims required the Claimants to prove that Mr Aplin was to some extent involved in the fraud perpetrated by Mr Saunders. As Sales J noted, this meant that

> "[t]his is a case in which the court's assessment of the witnesses and of the evidence they gave is of critical importance" (para 19).

Sales J reviewed the factual evidence in detail and reached the following factual findings:

- In the period between June 2009 and 22 February 2010, Mr Aplin thought that SEWL's accounts were being used for the purposes of an electrical wholesale business. Large cash withdrawals were made from the accounts but he was told by Mr Saunders that this was because his suppliers preferred to be paid in cash. Mr Aplin accepted this explanation and the Judge held that he was entitled to do so. Over this period of time, NatWest's anti-fraud department contacted Mr Aplin about the accounts on several occasions but each time, Mr Aplin was satisfied there was nothing untoward. In all, the Judge held that

"I accept Mr Aplin's evidence that he never suspected that Mr Saunders and SEWL were not operating a legitimate business" (para 67).

- On 22 February 2010, Mr Aplin found out that Mr Stone was mistaken about the accounts in question. In summary, Mr Stone thought that the NatWest accounts were being used to receive payments from suppliers in connection with the Hotel Business. Mr Aplin, on the other hand, thought the relevant accounts were being used to receive short-term loans from investors and that the Hotel Business revenue was being paid into a separate account with Barclays. Mr Aplin admitted that he did not correct Mr Stone's mistake but said he was worried about doing so for fear that he would breach the duty of confidentiality he owed to SEWL as the bank's customer. Mr Aplin discussed the matter with his line manager and concluded there was nothing he could do to bring the matter to Mr Stone's attention. NatWest submitted that this was the correct course of action for Mr Aplin to take and the Judge agreed.

These findings meant that the claims in deceit, dishonest assistance and conspiracy failed. Mr Aplin made no representations, did not act dishonestly and was not involved in a conspiracy with Mr Saunders (paras 236 to 239).

Unjust enrichment

The Claimants paid money into SEWL's accounts with NatWest and they obviously did so as a result of their mistake about the existence of the Hotel Business.

On this basis, they alleged NatWest was unjustly enriched at their expense with the result that NatWest was obliged to pay back the money it had received. NatWest denied any such liability, saying that it was not enriched at all and that even if it was, it had a defence of change of position or ministerial receipt.

The Claimants countered this by alleging that Mr Aplin was aware of the Claimant's mistake, with the result that neither defence was available and that, in any event, NatWest was barred from raising this defence by illegality.

Sales J accepted NatWest's defence to this claim, holding first that NatWest was not enriched at all. In his words:

- "242. As for the issue of enrichment, it is true that the Claimants paid sums to NatWest for the account of SEWL, NatWest received those sums and added them to its stock of assets as monies to which it was beneficially entitled. However, the increase in its assets was matched by an immediate balancing liability, in the form of the debt which NatWest owed SEWL reflected in the increase in SEWL's bank balance as a result of the payments. This is how the relationship between bank and customer works. There was no basis – at any rate known to NatWest at the relevant time as the receipts came in, credit entries were made on the accounts and payments were made against those credit entries – on which NatWest had any entitlement to withhold payment of sums representing credit balances on the accounts when instructed by SEWL to pay.
- 243. Therefore, in my judgment, NatWest was not enriched by the payments made by the Claimant into SEWL's bank accounts (in that regard, see *Box v. Barclays Bank Plc* [1998] Lloyd's Rep Bank 185 and *Compagnie Commercial André SA v. Artibell Shipping Co Ltd* (2001) SC 653, Court of Session, Outer House, at [16] per Lord Macfadyn). The Claimants' proper unjust enrichment claim is against SEWL, whose assets were increased upon the making of the payments to its bank accounts by the increases in its balances on those accounts (representing the debt owed to it by NatWest)."

In any event, Sales J held that NatWest had a good defence of change of position and ministerial receipt even after Mr Aplin became aware that Mr Stone was mistaken. The Judge held that Mr Aplin did not know about the fraud and had no proper basis for refusing to honour SEWL's payment requests.

The Judge then considered whether either of these defences was ruled on by virtue of alleged breaches by the Defendants of their duties under the Money Laundering Regulations 2007 and the Proceeds of Crime Act 2002 (POCA).

In summary, the Claimants said that the Defendants had failed to monitor their relationship with SEWL (contrary to Reg 8(1) of the Money Laundering Regulations 2007) and had failed to report criminal activity (contrary to s 330 of POCA).

This was said to be sufficiently serious criminal activity to bar the Defendants from relying on the defences of change of position and ministerial receipt.

The Judge rejected this argument for the following reasons:

(1) There was no breach of POCA, s 330 because Mr Aplin did not suspect money laundering and was not (therefore) obliged to report it. In any event, the Judge held that breach of s 330 would be:

"strict liability regulatory failures which were insufficiently grave

to debar NatWest from relying on the change of position defence." (para 251).

(2) There was no breach of Reg 8(1) because NatWest operated an automatic fraud detection system that provided adequate monitoring for the purposes of the Money Laundering Regulations 2007. There was no duty on relationship managers actively to monitor the accounts of their customers (paras 56 to 58 and 253). Equally, such a breach would have been *"technical in nature"* and would not have debarred NatWest from relying on the defence (para 254).

Negligence

The Claimants submitted that Mr Aplin assumed responsibility to them in relation to the accuracy of information he gave them concerning the accounts so that the Defendants came under a duty to take reasonable care to ensure such information was accurate. The Judge rejected this submission.

The Claimants were not signatories on the relevant accounts and it would be inconsistent with the Defendants' duty of confidentiality to SEWL for them to have assumed responsibility towards the Claimants (para 256).

COMMENT

Victims of a fraud often find that it is impossible to recover the amounts lost from the fraudster or the companies used for the purposes of the fraud. By the time the fraud is discovered, the money has long gone and the companies may well be insolvent. In these circumstances, it is natural to look to those who have received the money at various points in time in an attempt to recover the lost proceeds.

Banks and financial institutions play a crucial role in the movement of funds and it is inevitable that they will get caught in the cross-fire when it is later discovered that the proceeds of a fraud passed through their hands. The question then arises whether and in what circumstances the bank can incur personal liability for its involvement in the process by which the funds were dissipated.

It is well-established that the bank can be personally liable to the victim of a fraud if its employees were actively involved in the fraud or turned a blind eye to it. If the bank's employees acted dishonestly, there can be no objection to the bank incurring personal liability to the victim of the fraud. However, this case demonstrates how difficult it can be to establish dishonesty by employees of a reputable bank.

At first sight, the combination of large cash withdrawals, bounced cheques and repeated enquiries from NatWest's money laundering unit raised questions about the legitimacy of the business being conducted through the accounts. However, Mr Saunders and SEWL gave explanations for this conduct which Mr Aplin said he honestly believed. Despite a sustained attack by the Claimants, the Judge refused to reject Mr Aplin's evidence and found him to be an honest witness.

This left the possibility of claims in negligence or unjust enrichment, neither of which requires proof of dishonest behaviour by the defendant. It will require an unusual set of facts for a bank to assume a duty of care in tort to anyone other than the bank's customer. It is therefore unlikely that negligence will be a fruitful avenue in many cases.

However, a claim in unjust enrichment is not a fault-based claim. It arises in all circumstances where the defendant has received a quantifiable benefit in circumstances that render it unjust for the defendant to retain it (subject to defences). It is well-established that it is unjust for the defendant to retain money if the claimant paid the money by mistake (*Barclay's Bank v. WJ Simms Son & Cooke (Southern) Ltd* [1980] QB 677). This will often be the case where fraud is involved. Most victims of fraud pay in the mistaken belief that the underlying transaction is genuine. It follows that banks are potentially vulnerable to claims in unjust enrichment.

Sales J's judgment considerably limits the scope of this claim and will give banks and other financial institutions great comfort. However, his reasoning is open to criticism on a number of fronts and there is reason to believe that this will not be the final word on the viability of a claim in unjust enrichment in the circumstances of this case. The following points should be noted:

(i) The conclusion that a bank is not enriched when it receives money for the account of its customer is very significant. There can be no claim in unjust enrichment unless the defendant was enriched (*Portman Building Society v Hamlyn Taylor Neck (a firm)* [1998] 4 All ER 202, Millett LJ at p 206). Sales J held that there is no enrichment where the bank has credited its customer's account because the money received from the claimant is matched by a corresponding liability owed by the bank to its customer, leaving the bank no better off over all. This approach is doubtful as a matter of authority. A series of cases show that an agent who receives money for the account of its principal *is* enriched but may have a defence of ministerial receipt depending on whether the agent has paid the money over to the principal without knowledge of the claim (see Goff & Jones, *The Law of Unjust Enrichment*, paras 6–36, 28–03 and 28–14 to 28–15). These cases are also consistent with principle, since there can be no doubt that the bank received money as a result of the transfer and that the bank was entitled to use that money to make a profit. The existence of a corresponding liability to the customer is arguably only relevant to the question whether the defendant has a defence, such as change of position or ministerial receipt.

(ii) In any event, Sales J's reasoning can only apply if the bank *does* come under a corresponding liability to the customer. If the bank has no reason to believe there is any wrongdoing, it may have no basis for refusing to honour its customer's instructions. However, if the bank suspects wrongdoing or is

notified of a mistake by the victim (or its bank), it is not necessarily true to say that the bank remains *obliged* to honour the customer's instructions (see *Shah v HSBC Private Bank (UK) Ltd* [2012] EWHC 1283 (QB) and the note in (2012) 8 JIBFL 516). In these circumstances, the appropriate course of action is for the bank to interplead, pay the money into court and then drop out of proceedings.

(iii) If the analysis in (i) is correct (ie the bank is enriched), the bank will be liable subject to the defences of change of position and ministerial receipt. Both defences are available provided that the bank has paid the money over to its customer. Mere crediting of an account does not amount to a payment over (see *Jones v Churcher* [2009] 2 Lloyd's Rep 94 at para 69). However, once funds are withdrawn, there is unquestionably a sufficient payment over and the bank will have a cast-iron defence provided that: (iv) the bank acted in good faith in making such a payment; and (v) the bank did not commit a sufficiently serious criminal offence in allowing the payment to be made.

(iv) For the purposes of the law of unjust enrichment, a defendant does not act in good faith if the money is paid away at a time when the defendant knew the payments had been made by mistake (see *Cressman v Coys of Kensington (Sales) Ltd* [2004] 1 WLR 2775, Mance LJ at para 41). On the evidence, Mr Alpin first suspected there was a mistake (albeit not a fraud) with effect from 22 February 2010. It is arguable that this was sufficient knowledge to disbar NatWest from the defence for withdrawals that took place after this point in time. On the other hand, it might be said that Mr Alpin was entitled to conclude that there was a simple misunderstanding about which accounts were being used for what purpose and that this mistake would not give the Claimants a sufficient reason to call for return of the funds. If this is the case, the learned Judge's conclusion may be correct. Either way, the issue is far from clear.

(v) The question whether the defences are barred by illegality arises out of the decision in *Barros Mattos Jnr v MacDaniels* [2004] 3 All ER 299. It is not evident that a failure to report criminal activity under POCA is insufficiently serious to attract the application of this principle. However, the learned Judge's approach to the bank's compliance with Art 8(1) of the Money Laundering Regulations 2007 is of more general interest, since it endorses the use of automated fraud detection systems, particularly for larger banks. It also emphasises the limited extent to which relationship managers are required to monitor their customer's accounts.

In all, this decision provides a high degree of protection for banks from the consequences of their customer's fraud. However, it may well not be the final word on the subject and this area of law would benefit from a thorough examination by the Appellate Courts at a future date.

CLOSE OUT VALUATIONS UNDER THE 2002 ISDA MASTER AGREEMENT: HAS THE VALUE CLEAN PRINCIPLE HAD ITS DAY?

Re Lehman Brothers International (Europe) (In Administration)

Joint Administrators of Lehman Brothers International (Europe) v Lehman Brothers Finance SA

[2013] EWCA Civ 188

Court of Appeal (Munby PFD, Arden and Aikens LJJ, (with both of whom Munby PFD agreed)).

SUMMARY

An arrangement providing for termination of a back-to-back swap transaction if the main transaction were terminated should be taken into account in valuing the back-to-back transaction for the purposes of obtaining a "Close-out Amount" after the back-to-back transaction had been terminated. The close-out valuation provisions of the 2002 ISDA Master Agreement do not preserve the "value clean" principle as it applies to the 1992 Master Agreement.

FACTS AND ISSUES

Lehman Brothers International (Europe) (LBIE) laid off risks arising from its derivative trading with clients by: (i) entering into back-to-back transactions ("Inter-company Transactions") with another Lehman company, Lehman Brothers Finance SA (LBF); and (ii) signing a side letter (the "Side Letter") dated 24 July 2006 with LBF.

The Inter-company Transactions were carried out on the terms of an agreement (the "Master Agreement"), which followed the form of the 1992 form of the ISDA Master Agreement as modified to incorporate certain provisions of the 2002 form of the ISDA Master Agreement dealing with the consequences of termination.

The Side Letter provided: (i) for automatic termination of an Inter-company Transaction if the related "Client Transaction" was terminated; and (ii) for LBIE's obligations to LBF under Inter-company Transactions to be limited to the amount actually recovered from the client under the related Client Transaction.

An Event of Default under the Inter-company Transactions occurred, in respect of LBF, resulting in the automatic termination of those transactions pursuant to the terms of the Master Agreement.

The consequence of this default was that, under the Master Agreement, there had to be a determination of compensation by closing out the Inter-company Transactions in accordance with the Master Agreement. This involved determining gains or losses at the date of the closing out in replacing or providing the economic equivalent of the "material terms" (referred to in the case as the terms of a "replacement contract") of the Inter-company Transactions and assuming that all conditions precedent as to payment and delivery were fulfilled.

The question for the Court of Appeal was whether the provisions of the Side Letter should be treated as terms of the "replacement contracts" for the purposes of closing out the Inter-company Transactions.

BRIGGS J

At first instance, Briggs J held that the Side Letter was not a material term of the Inter-company Transaction and that it should therefore be left out of the ascertainment of the economic equivalent of the material terms. In the alternative, he held that if it was a material term, that term had no value.

COURT OF APPEAL

The Court of Appeal allowed the appeal. Arden and Aikens LJJ (with whom Munby PFD agreed) held that the Side Letter had to be taken into account as a "material term" and not a condition precedent.

CLOSE OUT PROVISIONS UNDER THE 1992 ISDA AND THE 2002 ISDA

Central to the case was the question whether principles that had been held to apply to the close out provisions in the 1992 ISDA should also apply to the new close out provisions under the 2002 ISDA. Under the 1992 ISDA, where there is an "Early Termination Date", the non-defaulting party has to calculate (amongst other things) the Close-out Amounts in accordance with s 6(e)(i). The parties have a number of options to choose from for the valuation of transactions which are still in existence at an Early Termination Date.

The most common is called "Second Method and Market Quotation". Under the definition of "Market Quotation" the non-defaulting party (the "Determining Party") has to obtain quotations from market makers for a replacement transaction. Each such quotation is to be for the amount, if any, that would be paid to or by such party in consideration of an agreement that would have the effect of preserving for the non-defaulting party:

> "the economic equivalent of any payment or delivery (whether the underlying obligation was absolute or contingent and assuming the satisfaction of each applicable condition precedent) by the parties under Section 2(a)(i) in respect of such Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required after that date."

Such valuations should include all payments or deliveries becoming payable after the Early Termination Date but exclude amounts payable or required to be settled prior to the Early Termination Date which remain unpaid at that date ("Unpaid Amounts").

Another method of closing-out under the 1992 ISDA is called "Second Method and Loss". The definition of "*Loss*" requires the Determining Party to make a determination in good faith of the total losses and costs (or gain) in connection with the relevant agreement or terminated transaction(s) and includes losses and gains in respect of any payment or delivery required to have been made (assuming satisfaction of each applicable condition precedent) on or before the relevant Early Termination Date.

The 2002 ISDA involved significant changes to provisions for close-out valuation. There is now only one payment measure ("Close-out Amount"), though the provisions for valuation have been made more flexible. The "Close-out Amount" is (as determined in good faith by the Determining Party) the amount of the losses or costs or gains of the Determining Party that are or would be incurred or realised under then-prevailing circumstances in replacing or providing for the Determining Party:

> "the economic equivalent of, (a) the material terms of that Terminated Transaction or group of Terminated Transactions, including the payments and deliveries by the parties under section 2(a)(i) in respect of that Terminated Transaction or group of Terminated Transactions that would, but for the occurrence of the relevant Early Termination Date, have been required after that date (assuming satisfaction of the conditions precedent in section 2(a)(iii)) and (b) the option rights of the parties in respect of that Terminated Transaction or group of Terminated Transactions."

Unpaid Amounts are excluded. In determining a Close-out Amount, a Determining Party may consider any relevant information, including quotations from third parties, which may take into account the creditworthiness of the Determining Party.

Section 2(a), which is referred to in the close-out provisions of both the 1992 and the 2002 ISDA, is expressed in the same terms in both versions:

> "2 Obligations
> (a) *General conditions*.
> (i) Each party will make each payment or delivery specified in each Confirmation to be made by it, subject to the other provisions of this Agreement.
> (ii) Payments under this Agreement will be made on the due date for value on that date in the place of the accounts specified in the relevant Confirmation or otherwise pursuant to this Agreement in freely transferable funds and in the manner customary for payments in the required currency. Where settlement is by delivery (that is, other than by payment) such delivery will be made

for receipt on the due date in the manner customary for the relevant obligation unless otherwise specified in the relevant Confirmation or elsewhere in this Agreement.

(iii) Each obligation of each party under Section 2(a)(i) is subject to (1) the condition precedent that no Event of Default or Potential Event of Default with respect to the other party has occurred and is continuing, (2) the condition precedent that no Early Termination Date in respect of the relevant Transaction has occurred or been effectively designated and (3) each other applicable condition precedent specified in this Agreement."

THE "VALUE CLEAN" PRINCIPLE

The Courts have previously held (in particular in *Australia and New Zealand Banking Group Ltd v Société Générale* [2000] CLC 833 and *Lomas v JFB Firth Rixson* [2012] EWCA Civ 419) that, under both the "Market Quotation" and "Loss" methods provided for by the 1992 ISDA, a Terminated Transaction must be valued disregarding any option or right of substituted or early payment that might be exercised prior to termination at term.

Accordingly, had either the Market Quotation or the Loss principles in the 1992 ISDA applied, then the close-out valuation would have ignored the Side Letter.

Briggs J observed that the wording of the 2002 ISDA was substantially similar to that of the 1992 ISDA. More importantly, the wording of s 2(a)(iii) was identical. Since the "value clean" principle was based on the construction of the concept of "condition precedent" in the ISDA, Briggs J found that the value clean principle had been preserved and also governed the terms of the 2002 ISDA. Briggs J said that the courts have held that the words "assuming the satisfaction of the conditions precedent in Section 2(a)(iii) and (b)" to mean that when you are calculating the "economic equivalent" of the Terminated Transaction, you have to assume that, but for the termination, the Terminated Transaction would have proceeded to a conclusion and that all conditions precedent to its full performance by both sides would have been satisfied, however improbable that presumption might be in the real world.

Briggs J said that if the Side Letter were held to be a material term then it would involve a "radical departure" from the value clean principle.

VALUATION OF A REPLACEMENT CONTRACT

The 2002 ISDA had to be construed on its own terms, of which three changes were particularly significant. First, the replacement contract whose economic equivalent is to be ascertained has been expanded from payment obligations to all the "material terms" (of which payment and delivery obligations are part). Secondly, option rights are expressly included. Thirdly, a quotation for a replacement contract may take into account the Determining Party's own creditworthiness.

The Court of Appeal held that the starting point was not the preservation of the value clean principle or the question of what is a condition precedent but the question, in respect of any agreement: what are the "material terms"? Briggs J had held that a material term is one that is material to the pricing of a hypothetical replacement transaction. This was not in dispute.

The Court of Appeal held that the Side Letter was a material term because it would be material to the pricing of a replacement transaction. It would undermine the concept of "material terms" if some material terms were then to be disregarded on the basis that they were (pursuant to cases like *ANZ* and *Lomas*) also considered to be conditions precedent to other material terms.

The Court of Appeal thus held that the value clean principle (which was a principle based on the true construction of the 1992 ISDA) does not apply in the same way to the 2002 ISDA. Once something is identified as a material term, it may be taken into account in the valuation exercise.

THE COMMENTARY IN THE ISDA USER'S GUIDE

Arden LJ also referred to the reasons behind the changes given in the *User's Guide to the ISDA 2002 Master Agreement*, published by ISDA in 2003 (the "User's Guide").

The User's Guide describes the changes as "significant" and gives a number of reasons for them. In particular, Arden LJ said that the changes were aimed at reducing avoidable risks to participants involved in carrying out a close out valuation.

Arden LJ noted that there was no statement in the *User's Guide* that the "value clean" principle either is, or is not, to be retained or modified. Nor was there any suggestion that terms which met the test of materiality were to be excluded in order to preserve the rigour of the value clean principle. Nor was there any mention of any restriction on the option rights that could be taken into account.

Accordingly, Arden LJ concluded that the retention of the value clean principle was not regarded as being as important as the changes to the text of the ISDA Master Agreement. The dominating feature in the construction of the 2002 ISDA, therefore, was the changes that had been made rather than the value clean principle as it had previously existed in the 1992 Master Agreement.

OTHER IMPORTANT CHANGES TO THE VALUATION PROCESS

As already noted, the Court of Appeal identified two other relevant changes to the wording of the 2002 ISDA. The first is the fact that option rights have been included. The second is that the creditworthiness of the Determining Party may be relevant.

As to option rights, Briggs J had found that this concept could be given a narrow meaning which did not encompass matters such as the side letter which would bring about the conclusion of a transaction earlier than would otherwise have been the case. Accordingly, he held that the inclusion of option rights did not undermine the value clean principle.

However, Arden LJ said that this was to prefer a principle of

construction of the 1992 ISDA to the actual words of the 2002 ISDA. The narrow definition would effectively deprive the concept of option rights of any relevant meaning.

As to the relevance of the Determining Party's creditworthiness, Briggs J appeared to accept the submission made on behalf of LBF that there was nothing wrong with identifying the relevant payment or settlement obligation, assuming that all conditions precedent had been satisfied and then adjusting the valuation to take into account the risk of the Determining Party's default. But the Court of Appeal held that the value clean principle was infringed by the permission to take account of the creditworthiness of the Determining Party because it was inconsistent with the assumption at the heart of the value clean principle that the transaction would be performed.

The Court of Appeal held that these further changes suggested that the value clean principle did not apply to the 2002 ISDA in the same way as it had to the 1992 ISDA.

COMMENT

The "value clean" principle has always been a difficult one for swaps lawyers. It involves a rather strained construction of the concept of a "condition precedent". The absence of the exercise of a right of early termination would not fall within the ordinary meaning of "condition precedent".

This construction was, at least, not inconsistent with the text of the 1992 ISDA. That could not be said for the 2002 ISDA. If the meaning and scope of the assumption of the satisfaction of conditions precedent were to be preserved, it would require giving a narrow meaning to new concepts in the 2002 ISDA: "material terms" and "option rights".

Beginning with the new words produces a different result from beginning with the old words. This difference of perspective explains the difference in approach between Briggs J and the Court of Appeal.

If one begins with the main payment or delivery obligation, then the conclusion of Briggs J makes sense. The courts have already held that arrangements like the Side Letter are to be considered "conditions precedent" to such payment obligations. So long as one proceeds on the basis that the meaning of the words, "assuming the satisfaction of the conditions precedent in Section 2(a)(iii) and (b)" has not changed, the effect of those words is that one must disregard the Side Letter, either because its terms are not material terms for the purposes of the valuation exercise or because they must be ascribed a nil value in such exercise (in either case, on the application of the value clean principle).

But if one begins, as the Court of Appeal did, with an assessment of the material terms in any replacement contract, then the reasoning of Briggs J is much more difficult. The terms of the Side Letter would clearly be material to price in the replacement of the agreement. And once that point is reached, it seems odd to disregard it on the basis that it is a condition precedent to another material term.

The first critical point for the Court of Appeal, then, was that the correct approach is to begin with the text of the 2002 ISDA, not the construction of the 1992 ISDA. The second critical point was that the words of the 2002 ISDA suggest the compromise, not the retention, of the value clean principle.

However one suspects that the Court of Appeal felt that the value clean principle, in the form applied to the 1992 ISDA, has had its day. Not only does it involve a strained approach to construction, it also threatens to produce uncommercial results for no good reason. If it is possible for a valuation to take into account matters such as the Side Letter; if arrangements such as the Side Letter are a central part of the bargain and allocation of risks between the parties; and if arrangements such as the Side Letter would have an appreciable effect on the valuation of a replacement transaction, it is very difficult to justify straining the concepts of "material terms" and "option rights" as well as maintaining the already strained construction of "condition precedent".

The other significant aspect of the decision that should be noted is the use by Arden LJ (with whom Munby PFD and Aikens LJ both agreed) of the User's Guide as an aid to construction. This may become particularly important as and when issues arise regarding other differences between the 1992 and 2002 ISDA Master Agreements such as the reduction of grace periods and the inclusion of a set-off clause. ■

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