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**Swaps, betting and the law**

**Acceptable delay in disclosure of inside information**

**The competing priorities of secured creditors and preferred creditors on insolvency**

**KEY POINTS**

- Contracts involving only the payment of differences (and not delivery) are wagers.
- In accordance with Lord Mansfield's "equal ignorance or equal knowledge" concept, for one party secretly to manipulate the "uncertainty" at the root of any wager is clearly not acceptable.
- The statutes contain no statement that the common law of wagering is altered, replaced or superseded.
- Enforcing this well-established principle would do much to benefit the financial markets generally.

Spotlight

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# Swaps, betting and the law

In this article Professor Julian Roberts finds an answer in the common law that could offer redress to buyers of loss-inducing "hedging swaps".

Derivatives play a central role in the modern financial markets. Although, in the hands of the unwary, they can lead to ruinous losses, provisions exist to limit such dangers. Principally, this is done by regulating the duties of originators towards their more vulnerable customers. The current Financial Conduct Authority (FCA)-sponsored review of interest rate hedging products (IRHPs) is an aspect of this regulatory intervention.

It is apparent, however, that administrative regulation can only go so far. The FCA review is guided by a generalised concern for the public's confidence in the retail market rather than by any clear legal principles. The banks – who are taxed with carrying out the individual reviews themselves – have felt comfortable taking a restrictive view of the review's terms.

Many buyers of loss-inducing hedging swaps have, as a result, been denied redress, and the FCA review has been followed by a penumbra of litigation.

Two main difficulties face intending litigants. One is that because the rules for marketing financial services are essentially administrative, they cannot, as a matter of principle, be invoked in a private damages action for breach of statutory duty. Parliament did create a right of action for certain "private persons", and this can also extend to corporates, but only as long as the disputed derivative agreement was not entered "in the course of business of any kind" (Financial Services and Markets Act (FSMA) 2000, s 150; SI 2001/2256 r 3(1)(b)). So far, the courts have always found that agreements were entered in the course of business (see eg *Grant Estates v RBS* [2012] ScotCS CSOH_133 (Scottish Court of Session 2012)).

The second difficulty is that almost all IRHP contracts were sold subject to extensive exclusion clauses. These throw upon the customer the entire burden of deciding whether a financial product is suitable. The English courts' concern for legal certainty has, by and large, led them always to uphold exclusion clauses of this sort (see eg *Springwell Navigation v JP Morgan Chase CA* [2010] EWCA Civ 1221).

## THE *NEXTIA* CASE

In a recent case, however, the claimant has attempted to take the issue back to first legal principles (*Nextia Properties Ltd v Royal Bank of Scotland* [2014] EWCA Civ 740).

The facts of this case were that Nextia, a property developer, bought from the defendants a five-year interest rate swap as a hedge, in order to "fix" the rate payable on its loans. Unfortunately, however, the loans themselves all had much shorter maturities. When the defendants refused to renew them except at significantly higher rates of interest, Nextia not only lost on the swap (because interest rates fell), but also had to pay more on the loans. The "hedge" thus failed to materialise, instead becoming a serious burden.

## Initial market value and risk

It was accepted that, on signature, the swap had a substantial market value to the benefit of the defendants. The market value of a derivative is based on the expected future cash flow under the deal. Although derived from statistical techniques, this value is not theoretical, but returns a price at which the instrument can be traded in the market. It forms the basis, *inter alia*, for calculating the "break costs" charged to customers who wish to exit before maturity.

As one is dealing with statistical expectations, the actual outcome will almost certainly be different. However, market value is not a "forecast", it is an empirical valuation elicited from present market data. A non-zero market value indicates that – given current expectations – the chances have shifted to the benefit of one side. The higher the value, the more extensive the shift.

Market value varies continuously throughout the life of the deal. At inception, market value will be zero if the expected cash-flow on both sides is the same; in that case the deal is described as "fair". But, of course, the risks of the instrument can be shifted so that the expected cash-flow is higher on one side. In effect, the value to the party which is "in the money" is directly proportional to the risk borne by the party which is "out of the money".

It was not disputed that Nextia was unaware of the swap's risks having been structured to its disadvantage.

## The swap "not a wager"

On this basis, Nextia argued two points of law. First, the interest rate swap was a wagering contract. Second, as a wagering contract, it was subject to the incidents of such contracts, which included an interdict on one side secretly improving its own chances of winning at the expense of the other.

On an application by the defendants to strike out under CPR 24, the court at first instance (HHJ Behrens) held, on the authority of *Morgan Grenfell v Welwyn* (QBD, AER [1995] 1 (QBD 1993)) that the disputed swap was not a wagering contract. The judge said:

> "I do not accept that this was a wagering contract. It is excluded from being a wager by s 10 of the Gambling Act. Furthermore it is plain that both parties intended that the Swap would act as a hedge against increased interest rates for the five-year

period that Mr Flavin envisaged that he would have outstanding loans of £2 million. As is made clear in Morgan Grenfell interest rate swaps are not usually treated as wagers. There is no reason to do so in this case." (para 74)

He also said that even if the swap had been a wager, there was no basis for implying a term that it was "fair", ie with a zero initial market value:

"To my mind it would be contrary to normal expectations to imply such a term. NatWest is a commercial organisation offering a service. It would expect to cover its costs and make a profit. If the Day 1 MTM was zero it would not do either." (para 76)

## THE COURT OF APPEAL

On an application for leave to appeal, Nextia pressed the point that contracts for differences, at common law, are invariably wagers. To the extent that he departed from this position, the judge in *Morgan Grenfell* had been at odds with higher authority. It should not be forgotten that Lord Goff, in the later case of *Westdeutsche v Islington LBC* [1996] 2 All ER 961, 961j (HL 1996), reiterated that interest rate swaps are, in law, wagers.

In the oral hearing, the Court of Appeal agreed with Nextia that the swap would indeed have been a wager at common law, and that it would not have conformed to the requirements thereby imposed. Nonetheless, said Vos LJ, it was plain that the common law had been superseded by statute. Financial "wagers" such as the swap would now be governed by a new regime contained in the financial services legislation of 1986 and 2000, and in the Gambling Act 2005. He said:

"Those pieces of legislation have, as it seems to me, established an entirely new and separate regime for the regulation of financial contracts. The fact that a contract for differences of the kind that is in issue in this case would have been regarded as a wagering contract at common law with all of the consequences that might flow from that must, as it seems to me, have been superseded by the modern legislation and in particular by ss 10 and 335 of the Gambling Act 2005." (para 22)

Thus, although Vos LJ refused permission to appeal, he adopted an entirely different tack from the High Court: in his view, at common law swaps were indeed wagers, and it was only in the recent past, following statutory reform, that they had ceased to be so.

Procedurally, this decision is questionable. It rests on the premise that the common law has been altered by statute – something which, as every law student knows, confronts the venerable presumption that no statute alters the common law unless it says so in clear terms. It is, of course, possible to rebut such a presumption, but the burden of doing so would in this case have lain on the defendants, who, however, had said nothing about it at the strike-out stage and were not represented in the permission hearing.

Judgments in applications for permission to appeal may not be cited as authorities (*Practice Direction (Citation of Authorities)* [2001] 1 WLR 1001). Nonetheless Vos LJ's argument leaves the law in a rather uncertain state. As the defendants pointed out at trial, legal opinion has generally assumed (despite Lord Goff's comment) that *Morgan Grenfell* was correct, and that swaps, at least in the banking context, are – at common law – not wagers. In the light of Vos LJ's judgment, this would seem, at least, to need revisiting.

## WAGER OR COMMERCIAL CONTRACT? "BOTH PARTIES" TEST

The background to these arguments, in summary, is as follows. In *Morgan Grenfell*, Hobhouse J seems to have approached the matter on the footing that "wagers" were on principle suspect. If, on the other hand, a deal had a "commercial" purpose – such as hedging a risk – moral reservations were clearly misplaced. So even if a deal could, in itself, be used for speculation, it was only a wager *if both parties intended this*. The test for "wagering", according to Hobhouse J, was therefore a subjective one.

However, as Lord Goff evidently noticed, this is a misreading of the authorities. English law, unlike, say, the civil law tradition, is morally neutral with regard to wagers. It invests them with certain structural characteristics (set out, classically, in *Carlill v Carbolic Smoke Ball Company* [1892] QBD 484 (QBD 1892)), and possesses a clear objective test for distinguishing wagers from other superficially similar contracts.

### Superficially similar contracts: futures and CFDs

The "superficially similar" contracts in question are futures on the one hand, and "contracts for differences" (CFDs) on the other. The difference can be illustrated in commodities deals. For example, A agrees on 14 February to supply B with 1,000 tons of wheat for delivery on 10 August, at a price of $292 per ton. By 10 August, as a result of disturbances in the Ukraine, the price has risen to $330. A delivers and receives $292,000, which represents a loss of $38,000 with respect to what she might otherwise have made on the spot market. B sells onwards on the spot market for $330,000, making a profit of $38,000. This contract is called a "futures" contract.

The same economic effect – loss to A, profit to B – can be achieved without delivery. In such a contract, A and B would, on 14 February "fix" a price, and on maturity (10 August), instead of delivery, the parties would merely make a payment reflecting the difference in price between the price fixed in February and the current spot price. In this example, A would pay B $38,000. This contract is a "contract for differences".

The same two possibilities arise in many areas of the market. Interest rates, for example, can be the subject of a forward rate agreement (the loan is delivered at a later date at a previously agreed "fixed" rate), or a swap (where only differences are paid). The former is a futures contract, the latter is a CFD.

### The delivery test

Although these two types of contract are indeed superficially similar, English law makes a fundamental distinction between them. Contracts involving delivery, such as futures, are, in the eyes of the law, "real" commercial contracts of exchange. Contracts involving only the payment of differences are wagers. Both can be used for "speculation" and other morally suspect purposes, but that is irrelevant. The test for distinguishing the two is simple: is the underlying property to be delivered? If so, it is a "real" commercial contract. If not, it is a contract for differences and thus invariably a wager.

There is only one situation in which a subjective test, as to the intentions of both parties, is applied, and that is where suspicion arises that a deal which on its face provides for delivery is accompanied by a secret intention to settle by the payment of differences only. Such "colourable" contracts were the subject of much litigation in the Victorian era: because wagers were at that time unenforceable, losers could try to avoid obligations under futures contracts by claiming that both parties never, in reality, intended to deliver (see eg *Thacker v Hardy* (1878) AC 685 (CA 1878)). That, however, is the only role for the "both parties" test.

This remains the case. *City Index* reiterates that the test for distinguishing between wagering and other contracts is delivery. As Leggatt LJ said:

> "Although before the 1986 Act came into force, contracts for differences were void, other contracts which are superficially similar were not. These were contracts entered into for a commercial purpose, such as hedging. Such contracts may result in no more than the payment of a difference. But because they were made for a commercial purpose, they are not void as wagering contracts. *That in practice is determined by whether the parties intended that any stock or commodity or other property should be delivered, by reference to which the contract was made. So in para 9 of Sch 1 [of FSA 1986] the note declares:*
>
> 'This paragraph does not apply where the parties intend that the profit is to be obtained or the loss avoided by taking delivery of any property to which the contract relates.'
>
> *"From this it follows that (a) delivery of property is made the test for distinguishing between a commercial contract and a contract for differences*, (b) the intention of both parties is made relevant, and (c) the obtaining of profit is equated with securing it." (per Leggatt LJ at 190d – *author's emphasis*)

(It is significant to notice that when Hobhouse J quoted this passage in *Morgan Grenfell*, he omitted all the words italicised.)

Swaps are CFDs. On a correct reading of binding authority, therefore, swaps must, at common law, invariably be wagers.

## THE STRUCTURE OF WAGERING CONTRACTS

Wagers, in English common law, are distinct sorts of contract. The accepted authority on their structure is contained in *Carlill*:

> "A wagering contract is one by which two persons, professing to hold opposite views touching the issue of a future uncertain event, mutually agree that, dependent upon the determination of that event, one shall win from the other, and that other shall pay or hand over to him, a sum of money or other stake; neither of the contracting parties having any other interest in that contract than the sum or stake he will so win or lose, there being no other real consideration for the making of such contract by either of the parties. It is essential to a wagering contract that each party may under it either win or lose, whether he will win or lose being dependent on the issue of the event, and, therefore, remaining uncertain until that issue is known." (per Hawkins J at 490)

Three things emerge from this definition. The first is that no "real consideration" flows under a wagering contract. In a wager, the only "consideration" is the mutual agreement to be bound by the outcome of a future event. Winning or losing itself is no more than a zero-sum transfer, and not to be mistaken for the consideration flowing under a commercial contract, where disparate items are exchanged and both participants benefit. This is logically equivalent to the "delivery" test we have just considered.

The second point is that the parties do not have any "interest" in the contract beyond the money won or lost. This distinguishes wagers from contracts of insurance, which are characterised by the existence of "insurable interest". Hedging swaps might well be regarded as insurance. However, this would involve additional burdens for any bank selling hedging instruments, and (as, indeed, in the *Nextia* case) they have tended to shy away from the suggestion.

### Equal ignorance: the uncertainty principle

The third point emerging from the *Carlill* definition is that the future event wagered upon must be "uncertain". This obviously excludes bets on events where one party has the power of determining the wager in his own favour (*Fisher v Waltham* (1843) 114 ER 1132 (1843)). As expressed by Lord Mansfield, uncertainty also covers a situation where one party has privileged knowledge of the "uncertain" event, with the consequence that the uncertainty is not "equal" as between the parties and there is no longer a position of "equal knowledge or equal ignorance":

> "The contract is equal between the parties; they have each of them equal knowledge or equal ignorance; and it is concerning an event which, reasoning by the rules of predestination, is to be sure so far certain, that it must be as it should afterwards happen to be. But it is a future event equally uncertain to the parties (*Jones v Randall* (1774) 98 ER (KB 1774))."

Whether or not privileged but undisclosed knowledge on its own violates this requirement is perhaps an open question. At all events, though, for one party secretly to manipulate the "uncertainty" at the root of any wager is clearly not acceptable. This must be the case when risks and chances of a financial derivative are shifted by one party without disclosing the fact to the other.

### Equal chance

Related to the principle of uncertainty is that of equal chance, which requires that "the chances are equally favourable to all participants" (Gambling Act 2005, s 8).

Equal chance is expressed by the

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Victorian commentator Stutfield as follows (G Herbert Stutfield, *The law relating to betting time-bargains and gaming*, 3rd ed. (London, 1892)):

> "Each event or contingency must, of course, be uncertain, or, at all events, unknown to the parties, that is, it represents a chance, and where the chances are agreed to be uneven the inequality is represented by odds." (p 34)

To a degree, this represents a position now superseded by modern gambling legislation, which does permit wagers in which the inequality of chance is *not* compensated by adjustment of the odds. Indeed, departure from equal chance – ie shifting the chances in one's own favour – is one of the distinguishing characteristics of modern commercial gambling (*ibid*, pp 7, 8).

Nonetheless, improving one's own chances in a wager has only come to be permitted recently and under narrowly restricted circumstances. In the initial liberalisation of gambling in the 1960s, shifting chances in the context of gaming was entirely disallowed, as was any other attempt by casinos to extract money from the gambling process itself (see s 32 (1) of the Betting, Gaming and Lotteries Act 1963).

These requirements have subsequently been relaxed for specified games and for betting (to which (b) didn't apply anyway), but only in the context of a regulatory framework which exhaustively enumerates the games, activities and instruments permitted.

Two points must be made about this. First, departure from equal chance is a specific concession in the context of regulated commercial gambling. It remains a requirement for all other wagers.

Secondly, departure from equal chance, even when permitted, does not violate the "equal ignorance" principle. The casino's advantage in roulette, for example, represents a departure from equal chance, but it does not depart from equal ignorance because both sides know all there is to know about the probable outcome (the green zero-pocket on the wheel – which gives the house its advantage – is visible to all). Commercial gambling enterprises are permitted to shift the risks and chances to benefit themselves, but that does not mean that they are allowed to do so secretly. Lord Mansfield's "Equal ignorance or equal knowledge" remains paramount.

## COMMON LAW ALTERED BY STATUTE?

The common law has a mature scheme of analysis for wagering contracts. It is not apparent that modern statutes have done any more than build on it.

Section 10 of the Gambling Act 2005, to which HHJ Behrens and Vos LJ both refer, provides that bets regulated by the FSMA are not "bets" for the purposes of the Gambling Act. This allows them to remain under the supervision of the Financial Services regulator (as had been recommended by the 2001 Budd report, CM 5206). It does not, however, mean that financial bets are "not betting", and has no bearing on the law otherwise applicable to such bets.

It is true that an important element of the Victorian law of wagering was altered by the FSA 1986 – namely, that financial wagers were henceforth to be *enforceable* (see Financial Services Act (FSA) 1986, s 63). However, the sanction of unenforceability was always a creature of statute, not of the common law (which regarded wagers as enforceable contracts). In that respect, s 335 of the Gambling Act 2005, which made *all* wagers enforceable, also has no bearing on the common law. Beyond this, the statutes contain *no* statement that the common law of wagering in general, or specific elements of it, is altered, replaced or superseded.

In any case, the chronology of the supposed "alteration" is entirely obscure. Is the common law supposed to have been replaced in 1986 (by the FSA), in 2000 (by the FMSA), or in 2005 (by the Gambling Act)? As far as the 1986 Act is concerned, the Court of Appeal in *City Index*, which was decided in 1991, and Lord Goff in *Westdeutsche Landesbank v Islington*, which was decided in 1996, both proceeded on the assumption that the common law applied.

In *City Index*, Leggatt LJ based his decision that the contract for differences at issue was a wager not on statute, but on common law authority, namely the *Carlill* case (which, as the current edition of *Chitty on Contracts* rightly says, contains the common law definition of a wagering contract – see Chitty 40-005, footnote 31).

It is not apparent that FSMA 2000 encroached any further on the common law in this respect, and as far as the Gambling Act 2005 is concerned, this statute explicitly does *not* concern activities regulated by the Financial Services legislation (GA 2005 s 10).

It is therefore unclear at what point, and in consequence of what provisions, the "replacement" of common law is supposed to have taken place. The only change statute has, perhaps, made to the common law is that departure from equal chance is now permitted in commercial gambling. That, however, does not mean it is permitted elsewhere, and, in any event, the cardinal principle of uncertainty ("equal ignorance") remains untouched in all contexts.

## CONCLUSION

Advances in statistics have made it possible to value financial risks on the basis of empirical data, and this has opened up a huge market for those with access to the technology. It is, however, complex and expensive, and well beyond the reach of any lay customer.

Allowing customers to assume risks of which they are ignorant, and profiting from that very fact, seems intuitively unacceptable. The courts have hitherto found it hard to see why it should also be legally unacceptable. There is, however, a clear answer in the common law. Swaps are wagers, and wagers that are not transparent to both parties are void. Enforcing this well-established principle would benefit not only a few aggrieved SMEs, but the financial markets in general. ■

*Further reading*

- Should losses on payer swaps be recoverable? [2012] 11 JIBFL 680
- Financial Derivatives: Investments or bets? [2011] 6 JIBFL 315
- Lexis PSL Corporate Crime: Spread betting and contracts for difference