LSE Research Online

THE LONDON SCHOOL OF ECONOMICS AND POLITICAL SCIENCE

Jo Braithwaite

Thirty years' law: local authorities, national courts and the global derivatives markets

Article (Accepted version) (Refereed)

Original citation:
Braithwaite, Jo (2018) Thirty years' law: local authorities, national courts and the global derivatives markets. Current Legal Problems. ISSN 0070-1998
DOI: 10.1093/clp/cuy005

© 2018 The Author

This version available at: http://eprints.lse.ac.uk/87352/
Available in LSE Research Online: March 2018

LSE has developed LSE Research Online so that users may access research output of the School. Copyright © and Moral Rights for the papers on this site are retained by the individual authors and/or other copyright owners. Users may download and/or print one copy of any article(s) in LSE Research Online to facilitate their private study or for non-commercial research. You may not engage in further distribution of the material or use it for any profit-making activities or any commercial gain. You may freely distribute the URL (http://eprints.lse.ac.uk) of the LSE Research Online website.

This document is the author's final accepted version of the journal article. There may be differences between this version and the published version. You are advised to consult the publisher's version if you wish to cite from it.

http://eprints.lse.ac.uk

Thirty years' law: Local authorities, national courts and the global derivatives markets

[Author]*

Abstract: Between 1987 and 1989, Hammersmith and Fulham London Borough Council entered into nearly 600 derivatives transactions. In 1991, the House of Lords held that it lacked the capacity to do so and the contracts were therefore void. Taking this landmark litigation as its starting point, this article seeks to explain the persistence and evolution of the problem of ultra vires, as it has affected local authorities participating in the derivatives markets. Specifically, the article traces how the derivatives markets have transformed beyond recognition in terms of their size, complexity and global reach over the three decades since the Hammersmith litigation, and it explores the resulting changes in the ultra vires disputes which come before the English courts. The article goes on to examine in detail the recent 'second wave' of ultra vires decisions, involving public bodies from Norway, Holland and Italy, amongst others. The analysis demonstrates how the global nature of the contemporary financial markets has further complicated the ultra vires problem, generating novel and difficult questions for the English courts. The article concludes that this area of law now contains a significant contradiction, between the English courts' market-minded approach on the one hand, and the harshness of the traditional doctrine of ultra vires on the other.

Introduction

Today's global derivatives market is unrecognisable compared to that of thirty years ago, when Hammersmith and Fulham London Borough Council entered into its 592 ill-fated swaps. In the 1980s, this market was so new that the Divisional Court, in the course of the subsequent litigation involving the council, provided a glossary of terms at the end of its judgment. By 2017, the notional value of the market was $542 trillion,[1] while a single derivatives clearing house in London cleared contracts worth a record $873 trillion notional value in the same year.[2]

This dramatic transformation has been driven by a combination of globalisation and contractual standardisation. The latter is largely a result of the success of the Master Agreement published by the trade association, the International Swaps and Derivatives Association (ISDA). One reason for the dominance of this contractual framework is that it

---

* [ ]

[1] Bank for International Settlements, 'Global OTC derivatives markets: semi-annual statistics for notional amounts outstanding, H1 2017' (2 November 2017) <https://www.bis.org/statistics/derstats.htm> all websites last accessed 25 February 2018.

[2] Helen Bartholomew, 'LCH hits swaps clearing records amid Brexit noise' *Reuters* (8 January 2018) <https://www.reuters.com/article/lch-hits-swap-clearing-records-amid-brex/lch-hits-swap-clearing-records-amid-brexit-noise-idUSL8N1P32P8 >

facilitates cross-border trading. More specifically, its 'orderly contractual structure'[3] is supported by legal opinions for use in over sixty jurisdictions, ranging from Anguilla to the USA,[4] and bolstered by safe harbour legislation in major jurisdictions worldwide.[5] The overall effect is to neutralise or mitigate a range of potential risks to the legal framework supporting this international market.[6]

One risk, however, has defied a neat solution during this transformative period. This is the problem of ultra vires, as it has affected local authorities participating in the derivatives market. The problem first arose in this jurisdiction in litigation concerning the swaps entered into by Hammersmith and Fulham council in the late 1980s, and it continues to generate significant litigation today. As well as longevity, the problem is characterised by its gravity and complexity. It consistently raises difficult and novel legal questions, while the fact that a lack of capacity is 'inextricably linked with nullity'[7] in English law means that the stakes are invariably high.

This article explores the concurrent evolution of the derivatives market and of the law around the capacity of local authorities to participate in them. The argument is developed in four parts. The first part of the article considers the English doctrine of ultra vires, focusing on its application to statutory bodies including local authorities, the problems long-associated with ultra vires and the piecemeal legislative response. The second part analyses the landmark litigation involving Hammersmith and Fulham council and it explains the enduring significance of the decision. The following part of the article identifies a 'second wave' of local authority ultra vires decisions which has subsequently occurred in the English courts, explaining the relationship between the quantity and qualities of these cases and the evolution of the underlying market. The fourth part of the article explores the themes which emerge from this set of cases. It demonstrates that while the legal reasoning behind recent decisions is expressly 'internationalist' and market-minded, the applicable legal framework means that the traditional English ultra vires doctrine may still apply to produce harsh, and sometimes unexpected, results.

It is important to note upfront that this ultra vires problem has triggered litigation in civil and criminal courts around the world and has also led to claims before international arbitral tribunals.[8] Whilst engaging with the international dimension to recent ultra vires disputes, this article focuses on the English courts (and principally, but not always, on English law). In part, this focus is required for reasons of space, but it also reflects the international role that the English courts fulfil in the derivatives market. While the English courts have long been a forum of choice in global commerce (in 2016, 45% of cases in the English Admiralty and Commercial Courts involved no parties from the jurisdiction and 70% involved at least one international party),[9] they play a particularly important function in the global derivatives market. This influence reaches far beyond the jurisdiction, and, as explained below, is thanks principally to choices made under the widely-used ISDA terms.

---

[3] *Banco Santander Totta v Cia Carris de Ferro de Lisboa* [2016] EWHC 465 (Comm), [2016] 4 WLR 49 [400] (Blair J).
[4] ISDA, Opinions Overview < https://www.isda.org/opinions-overview/ >
[5] For example, Directive 2002/ 47/ EC of the European Parliament and of the Council of 6 June 2002 on financial collateral arrangements.
[6] As discussed in Joanna Benjamin, *Financial Law* (OUP 2007) Chapter 14 ('The Rise of Net Positions) and as demonstrated in practice by the study conducted by Annelise Riles, *Collateral Knowledge* (University of Chicago Press 2011).
[7] *Haugesund Kommune v Depfa ACS Bank* [2010] EWCA Civ 579, [2012] QB 549 [135] (Etherton LJ).
[8] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2011] EWHC 1785 (Comm)
[9] TheCityUK (sic), 'Legal Excellence, Internationally Renowned: UK legal services 2017' (November 2017) 4. < https://www.thecityuk.com/research/legal-excellence-internationally-renowned-uk-legal-services-2017/ >

Ultra Vires and Local Authorities

The capacity of statutory bodies

The capacity to enter into a contract means different things in the context of natural persons and statutory bodies. The rules around the capacity of natural persons flow from the overarching principle of freedom of contract. Accordingly, a person of full capacity is able to make the contracts they like subject only to piecemeal regulation, for example in cases of undue influence, illegality or fraud. The starting point for a statutory body, such as a company, a building society or a local authority (including a borough council) is different. Statutory bodies may only act within the capacity that they have been given. As Lord Templeman put it in *Hazell v Hammersmith & Fulham London Borough Council*, a local authority 'is not a sovereign body and can only do such things as are expressly or impliedly authorised by Parliament.'[10] Any actions beyond those powers will be ultra vires. Contracts entered into ultra vires will be a nullity, or wholly void in law.[11] *Credit Suisse v Allerdale Borough Council*[12] confirmed that a contract cannot be partly ultra vires, nor were there 'categories of invalidity'.[13] To the well-known English maxim of 'fraud unravels all';[14] we might add 'unless ultra vires gets there first'.

The purpose of the doctrine of ultra vires is two-fold. In *Cotman v Brougham*[15] Lord Parker stated that the objectives in the context of a company were first, to afford 'protection to subscribers', who accordingly know what the company will do with their investment; and secondly, the 'protection of persons who deal with the company', who may see from the company's 'objects in its memorandum' what sorts of transactions a company is permitted to enter into. In the context of a local authority such as Hammersmith and Fulham LBC, the question of the lawfulness or otherwise of the council's swaps transactions, as the Court of Appeal put it, boiled down to 'the use or misuse of the council's funds.'[16]

Problems with the ultra vires doctrine

The statements above suggest a bright line between lawfulness and unlawfulness; use and misuse. Practice, however, is more complicated. There is a long history of cases considering the capacity of statutory bodies and who should bear the losses when it is missing. These cases have been accompanied by a long-running academic commentary, particularly in the corporate context.[17] Two main criticisms of the doctrine run throughout this debate.

---

[10] *Hazell v Hammersmith and Fulham London Borough Council* [1992] 2 AC 1 (HL), 22B (Hazell HL).

[11] As explored below, the exact consequences of the nullity for the different parties involved will depend on the facts of the case ibid 36E. In the context of a company, the classic statement of the position is found in *Rolled Steel Products (Holdings) Ltd v British Steel Corpn* [1986] Ch 246 (CA), 304-305 (Browne-Wilkinson LJ).

[12] [1997] QB 306.

[13] ibid 343 (Neill LJ).

[14] A common translation of ex turpi causa non oritur actio, eg, *United City Merchants (Investment) Ltd v Vitrorefuerzos SA* [1983] 1 AC 168 (HL), 184 (Lord Diplock).

[15] [1918] AC 514 (HL), 520.

[16] *Hazell v Hammersmith and Fulham London Borough Council* [1990] 2 QB 697 (CA), 776 (Sir Stephen Brown P) (Hazell CA).

[17] Going back to, eg, KW Wedderburn, 'What is the point of ultra vires?' (1966) 29 Modern Law Review 191; R Baxt, 'Is the doctrine of ultra vires dead?' (1971) 20 International and Comparative Law Quarterly 301; KW Wedderburn 'Ultra vires in modern company law' (1983) 46 Modern Law Review 204.

First, in English law it is irrelevant if a third party contracting with a body acting ultra vires lacks notice of the fact, while ultra vires acts may not be ratified later.[18] As a result, losses are often borne by third parties acting in good faith. In *Allerdale BC* the Court of Appeal highlighted the resulting vulnerability of parties which contract 'in ignorance of any procedural defect which may later entitle the public body to claim that the contract was made ultra vires and so reject liability under it.'[19] Indeed, an article cited in this case was entitled 'Do banks dare to lend to local authorities?'.[20] In *Allerdale BC*, the bank's guarantee from the council was ultimately held to be void, and its losses ran to nearly £6 million. Peter Gibson LJ described the council's use of its own unlawful act to avoid payment as a particularly 'unattractive feature' of the case[21] while in the same case Neill LJ stated that he did not regard 'the present law to be satisfactory.'[22] Nonetheless, nullity and the impossibility of ratification persist as the 'two badges of a transaction which is ultra vires'.[23]

The second problem relates to the unpredictability of determinations about particular transactions, which is compounded by the fact that ultra vires disputes tend to arise in the context of innovative business practices never envisaged at the time that the operative statute was drafted. As Martin Loughlin has put it, judges may be faced by a choice between two 'plausible interpretations of the powers [of the entity in question]' so, in the end, much will turn on the judiciary's characterisation of the transaction in question, and the local authority's relationship to it.[24] Similarly, in the corporate context, Paul Davies and Jonathan Rickford observed that the doctrine of ultra vires leads to 'highly technical and unpredictable results'.[25] The 1875 decision of the House of Lords in *Ashbury Railway Carriage & Iron Co v Riche*s[26] shows how difficult this type of choice can be in practice. Reversing the lower courts' decision, the Lord Chancellor Lord Cairns noted the case's messy history, involving a 3:3 split between the six judges of the appellate Exchequer Chamber and seven years of litigation in total, which he stated was 'not, I must say, creditable to our legal proceedings'.[27] Very similar charges, as we shall see, were levelled at the courts in the bitter aftermath of the Hammersmith and Fulham LBC litigation.

'Solving' the ultra vires problem

In theory, a 'solution' to disputes about ultra vires actions by statutory bodies is simple, assuming a suitably-inclined legislature. In practice in the UK, mounting criticisms of the ultra vires doctrine have resulted in incremental legislative reforms affecting numerous types of statutory body.

Most importantly for this purpose, under the Localism Act 2011 (the '2011 Act'), which came into force on 18 February 2012, local authorities in England are now allowed to do 'anything that individuals generally may do'.[28] This 'general power of competence' was portrayed by the Coalition Government behind the 2011 Act as an initiative to 'pass power

[18] *Ashbury Railway Carriage & Iron Co v Riche* (1874-5) LR 7 HL 653 (HL).
[19] *Allerdale BC* (n 12) 344 (Neill LJ).
[20] Peter Cane, 'Do Banks Dare to Lend to Local Authorities?' (1994) 110 LQR 514.
[21] *Allerdale BC* (n 12) 344
[22] ibid.
[23] *Rolled Steel Products* (n 11) 305 (Browne-Wilkinson LJ).
[24] Martin Loughlin, 'Innovative Financing in local government: The limits of legal instrumentalism Part 2' [1991] Public Law 569, 595.
[25] Paul Davies and Jonathan Rickford, 'An introduction to the new UK Companies Act' (2008) 1 ECFR 48, 57.
[26] *Ashbury Railway* (n 18).
[27] ibid 663.
[28] Localism Act 2011, s 1(1).

back to where it belonged'[29] and as having turned 'upside down' traditional assumptions about the capacity of statutory bodies.[30] Significantly, unlike its predecessor, the 'well-being' power introduced by section 2(1) of the Local Government Act 2000, there is no obligation upon local authorities to identify a specific benefit when exercising the new general power of competence.[31] Other, more specific reforms relating to local authorities' capacity to enter into contracts were implemented by the Local Government (Contracts) Act 1997. Section 2 permits a local authority to certify that a contract is intra vires, subject to meeting certain conditions (set out in section 3, including identifying the statutory power under which the contract is made). The result of a properly made certification is that the contract in question takes effect as an intra vires one and this has been described as providing an 'important exception' to the ultra vires doctrine.[32]

The Explanatory Note to the 2011 Act states that the general power of competence 'may be used in innovative ways … unlike anything that a local authority–or other public body–has done before, or may currently do.'[33] The practical effect of the new power, however, remains up for debate. In one example of new activities facilitated by this reform, a 2016 House of Commons Briefing Paper reported that it has enabled local authorities to set up companies to trade for commercial purposes more freely than they did in the past.[34] However, there remain important express limits on what a local authority can do, including that the general power will not enable a local authority to override any 'pre-commencement limitation' to its activities.[35] This term is defined as 'a prohibition, restriction or other limitation expressly imposed by a statutory provision'[36] found either in the 2011 Act, passed before the end of the parliamentary session in which the 2011 Act was passed, or contained in an instrument made under another Act which came into force before the commencement of the 2011 Act. The various limits to the general power of competence found in the 2011 Act and in the common law[37] are such that they leave the door open to uncertainty and even litigation, not least because, as a leading QC observed, 'the rationale for the Bill was largely left unexplained before its introduction…'.[38] The 2011 Act therefore represents an important change for local authorities both ideologically and in practice, but the general power of competence is neither untrammelled nor uncomplicated.

A more radical and clear-cut example of new legislation ousting the traditional doctrine of ultra vires[39] is found in the Companies Act 2006 which provides that, subject to any express limits in the articles of association, the objects of a company are unrestricted.[40] Section 39(1) further provides that an act of a company may not be challenged on the ground

---

[29] Department for Communities and Local Government, 'A plain English guide to the Localism Act' (15 November 2011) 1.
[30] ibid 4.
[31] Discussed in Ashley Bowes and John Stanton, 'The Localism Act 2011 and the general power of competence' [2014] Public Law 392, 392-394.
[32] Hugh Beale (ed), *Chitty on Contracts* (32nd edn, Sweet & Maxwell 2015) [11-021].
[33] 2011 Act, Explanatory Note [10].
[34] Mark Sandford, *The General Power of Competence* (House of Commons Library Briefing Paper Number 05687, 2016) [3.4].
[35] 2011 Act, s 2(2)(a).
[36] ibid s 2(4).
[37] The question of whether the general power is subject to judicial review is discussed in Bowes and Stanton (n 31) 397-400.
[38] Helen Mountfield QC, 'The 'General Power of Competence' in the Localism Act 2011: Devolving Democracy or the End of Accountability?' (14 October 2012) Public Law Project Conference, 2.
[39] For discussion of the position of different statutory bodies, including Limited Liability Partnerships, see GH Treitel, *The Law of Contract* (Edwin Peel ed, 14th edn, Sweet & Maxwell 2015) [12-066]–[12-070].
[40] Companies Act 2006, s 31(1).

of lack of capacity by reason of anything in the company's constitution. In effect, the regime implemented by the 2006 Act extinguishes the doctrine of ultra vires in this context.[41]

Overall, therefore, recent legislative reforms have diminished the significance of the doctrine of ultra vires for the most important types of UK statutory bodies. The position for local authorities is less clear-cut than that for companies, but the 2011 Act has fundamentally shifted the central presumption in this area of law. Nonetheless, as the remainder of the article will show, the traditional and unchecked version of the English doctrine of ultra vires, seen in full force in the Hammersmith litigation, remains as relevant as ever in the modern derivatives market.

Hazell v Hammersmith & Fulham LBC

The landmark case of *Hazell*

Hazell v Hammersmith and Fulham LBC is one of the most significant cases in English law, and it remains controversial thirty years after the events behind the litigation.

Some background is necessary in order to explain how this dispute came to have such lasting significance. In the 1980s local authorities in the UK were spending more and receiving less, partially as a result of this period's 'botched experiments' in monetary policy which had seen prices and unemployment soar,[42] and partly because of declining levels of central government grants.[43] Other sources of local authority income, including rates and rents, were falling and borrowing was on the rise. Local authorities at the time borrowed from both the Public Works Loan Commissioners and the money markets, at variable and fixed rates of interest,[44] and this was in a period when variable meant variable.[45] Interest rate swaps were one of several novel arrangements that local authorities started to enter into in this period to avoid central government's expenditure cuts, sidestep penalties, maximise grants and bolster revenue.[46] As Lord Templeman observed

> The evidence discloses that about 1981 there appeared in the world of international finance a new swap market comprising interest rate swaps, currency swaps and, recently, asset swaps.[47]

In December 1983 Hammersmith and Fulham LBC ('Hammersmith') entered into its first derivative transaction; other local authorities were entering into the markets at the same time. Initially, two or three such swaps a year were carried out by Hammersmith, the number rising modestly in 1986-87 to seventeen, with a total notional principal of £112m. Hammersmith's

---

[41] For a discussion of this part of the 2006 Act, see David Kershaw, *Company Law in Context* (OUP 2009) 108.

[42] Mark Carney, 'Opening remarks to the Bank of England 'Independence–20 years on' Conference' 28 September 2017 <www.bankofengland.co.uk/speeches>
In this speech, Carney notes that prices rose by 750% in the twenty five years to 1992, more than over the 250 years before that.

[43] As described in Martin Loughlin, 'Innovative financing in local government: the limits of legal instrumentalism. Part 1' [1990] Public Law 372

[44] Hazell HL (n 10) 32.

[45] Bank of England base rate was changed twelve times in 1975 alone, fluctuating from a high of 12% in October to a low of 9.75% in April (compare the current rate, which was 0.5% from March 2009 to August 2016). The Bank of England, 'Statistical Interactive Database: Official Bank Rate history' <https://www.bankofengland.co.uk/boeapps/iadb/Repo.asp >

[46] Loughlin (n 43) 377.

[47] Hazell HL (n 10) 23.

activity was at this point in keeping with comparable London councils. While its 1983-1987 swap contracts were not challenged in the litigation, the court assumed that they were being used as 'parallel contracts' to manage the interest rate risk in an underlying debt.[48] This means, as expressed in the Court of Appeal decision, that they were being used to meet the 'legitimate concerns' with regards to a specific underlying obligation.[49]

In 1987, unbeknownst to the council's leadership,[50] Hammersmith's finance department's strategy changed radically.[51] Appendix B to the Divisional Court decision demonstrates how spectacularly Hammersmith increased its dealings in the two financial years 1987-89, which were the subject of the subsequent litigation. In this period, the council entered into 592 transactions involving a principal notional sum of £6 billion. By comparison, the council's expenditure for 1988-89 in discharging all of its other functions amounted to £85.7m.[52] While there were no 'reliable statistics' about local authorities' swap activities or Hammersmith's exact market share,[53] it was estimated that at this time, Hammersmith accounted for 0.5% of the entire global market in derivatives[54] and about 10% of the interest rate swap market in the UK.[55] As Duncan Campbell-Smith put it, '[e]ven more astonishing than Hammersmith's dilatory handling of the crisis was the sheer financial scale of it'.[56]

In June 1988, the regulatory body for local authority auditors, the Audit Commission, was tipped off about Hammersmith's portfolio. It sent auditor Tony Hazell of Deloitte, Haskins & Sells to investigate, and later sought a legal opinion from two barristers on the lawfulness of the swaps.[57] Meanwhile, from July 1988 the council began to pursue what became known as an 'interim strategy' with the intention of managing the risk of the council's open positions, but the crisis continued to mount. Once the Government refused to sanction further trades by the council or indemnify councilors and officers involved,[58] the council ceased all activity in the derivatives market and litigation followed in short order.

This litigation was not a 'David and Goliath' fight between the local authority and its banks. Rather, the case was brought by the council's auditor for a declaration from the court under section 19(1) of the Local Government Finance Act 1982 that the swaps transactions entered into by Hammersmith in the financial years 1987-88 and 1988-89 were entered into without authority and were therefore unlawful, and that the council's accounts be rectified accordingly. In fact, the banks had to seek permission to become involved in the case, and over thirty 'aggrieved banks'[59] formed an action group to co-ordinate litigation and split the legal fees. Five banks representing a cross-section of transactions were subsequently given

[48] Hazell CA (n 16) 766 (Sir Stephen Brown P).
[49] ibid 765 and 780-781 (Sir Stephen Brown P).
[50] *Hazell v Hammersmith and Fulham London Borough Council* [1990] 2 WLR 18 (QBD), 26 (Hazell DC).
[51] While a portion of the 1987-89 transactions were interest rate swaps, the majority were more complicated varieties of interest rate derivatives as defined in Hazell DC (n 50) Appendix A.
[52] ibid 24 and Appendix B.
[53] V.V. Veeder QC, John Barratt and Michael Reddington, 'The Final Report of the Independent Inquiry into Capital Market Activities of the London Borough of Hammersmith and Fulham' (July 1991) (Veeder Report) 6-17 and 6-18.
[54] Duncan Campbell-Smith, Follow the Money: The Audit Commission, Public Money and the Management of Public Services, 1983-2008 (Allen Lane 2008) 192.
[55] Veeder Report (n 53) [6-18].
[56] Campbell-Smith (n 54) 192.
[57] The two barristers returned three legal opinions. A joint opinion stated that derivatives were generally ultra vires counsel. The QC opined separately that 'parallel contracts' were lawful, and junior counsel provided another opinion stating that all derivatives were unlawful. ibid 190.
[58] ibid 195.
[59] Patrick Stewart and Richard Phillips, 'The Deals of 1991' (January 1992) 11(1) International Financial Law Review 14.

permission by the court to join the litigation as respondents.[60] Otherwise, the banks feared, 'nobody would have argued the market'.[61]

This case was not, therefore, started by councils in order to avoid their contracts (indeed some were doing quite well from them) but it nonetheless affected an estimated 77 local authorities across the UK which, between them, had reportedly entered into 400 swap transactions with 76 banks and financial institutions, representing around one third of all sterling-based swaps.[62] As such, *Hazell* was self-evidently a test case, albeit an unusual one involving an outlier council and a coordinated group of banks which was providing the adversarial element at its own request.

The powers of the local authority

As already noted, statutory bodies only have the capacity they are given. There was no express statutory power authorising the council to enter into the swap transactions in the Local Government Act 1972,[63] or indeed forbidding them from doing so.[64] As the Court of Appeal observed, this lack of coverage was not surprising given that the swaps market had emerged after the relevant statute came into force.[65] Furthermore, all the parties to the litigation accepted that local authorities had no powers (express or implied) to engage in a trade or business for profit.[66] This meant that local authorities had no powers to enter to into swaps with a view to ploughing profits back into legitimate functions.

Accordingly, the council's powers to carry on swaps depended on the interpretation of section 111(1) of the Local Government Act 1972 (the Act), the relevant part of which stated

> (1) Without prejudice to any powers exercisable apart from this section but subject to the provisions of this Act … a local authority shall have power to do any thing (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which **is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions**.[67]

The House of Lords and both lower courts all accepted that the 'functions' of a local authority referenced in section 111(1), which had no express definition in statute, meant those activities that Parliament authorised it to undertake elsewhere in the Act.[68] This included the power to borrow, which was governed by section 172 of the Act and the 'extremely detailed provisions'[69] of Part I of Schedule 13. Hammersmith's borrowings amounted to £390m as at 31 March 1989, and were subject to a mixture of fixed and variable rates. The pivotal

[60] Midland Bank, Security Pacific National Bank, Chemical Bank and Mitsubishi Finance International Ltd and Barclays Bank. The last of these was separately represented and made slightly different submissions, for eg, Hazell CA (n 16) 770.

[61] Irene Dorner, the head of legal services at Midland Montagu Bank, quoted in Stewart and Philips (n 59) 15.

[62] Hazell CA (n 16) 764. Veeder Report (n 53) [6-17], noting that there were no reliable statistics for local authority involvement in swaps, but citing a variety of sources for the estimates reproduced above.

[63] Hazell DC (n 50) 35.

[64] Hazell CA (n 16) 779.

[65] ibid.

[66] ibid.

[67] This author's emphasis.

[68] Hazell HL (n 10) 29 (Lord Templeman) and ibid 45 (Lord Ackner). All the *Hazell* decisions were in agreement on this point: Hazell CA (n 16) 785 and Hazell DC (n 50) 36.

[69] Hazell HL (n 10) 45C (Lord Ackner).

question was therefore whether swap transactions could be said either to 'facilitate', or to be 'conducive or incidental to' the function of borrowing.

Divisional Court and Court of Appeal

The Divisional Court handed down judgment on 1 November 1989. It held that a local authority had no authority to enter into swaps, and that consequently, all of Hammersmith's 592 transactions were void. While borrowing and investing were functions of the local authority, swap transactions were not incidental to those functions for the purpose of section 111(1). They were only capable of being 'incidental to the incidental' function of paying interest. In addition, the Court observed that there had been no proper delegation of the council's powers to its officers, and that the council's capital market fund was not validly established.

In February 1990, the Court of Appeal overruled the Divisional Court, holding that swaps entered into by the council for risk management purposes were capable of being lawful. The decision emphasized the need to look at the 'type of purpose' not the 'type of transaction' in order to determine the validity of a swap.[70] Specifically, the Court of Appeal held that it was lawful for the council to enter swaps with the purpose of 'interest rate risk management', which was held to be 'incidental to or consequential upon a local authority's powers of borrowing and investment'.[71] The distinguishing feature of a swap which served this purpose was that it had a 'clear linkage' to a *particular* debt or investment, ie, 'parallel contracts' were lawful.[72] By contrast, a swap entered into for 'trading' purposes including where the council intermediated a deal for another party in return for a profit,[73] would not be lawful.

The Court of Appeal concluded that, when serving this risk management function, swaps merely provided a 'newly-fashioned tool which achieves, more economically and expeditiously, substantially the same commercial result as could lawfully be achieved in the discharge of the duty by more traditional means.'[74] If a council had borrowed under a fixed rate loan when interest rates started to fall, one lawful option was to take out a new loan to pay off the fixed rate debt, but this was likely to incur an early repayment fee. The Court of Appeal recognised that interest rate swaps could achieve the same, beneficial outcome more cheaply and more easily.

However, it became apparent within the Court of Appeal's own judgment that even a narrow and simplified definition of 'investment rate risk management' was problematic when applied to a real-world deals. The problem was that the court either must try to determine a party's intention relating to blocks of activity over a particular timespan, or undertake a 'deal by deal' analysis in order to adjudicate the purpose of every one of the hundreds of disputed transactions. Following the broader approach of looking at blocks of deals, the Court of Appeal held that the councils' transactions up to July 1988 were *all* 'tainted with the improper purpose of trading' for the 'one clinching fact' that there was no evidence that the council had attempted to analyse the interest it was exposed to or evaluate how to mitigate its risks.[75] By contrast, from July 1988 to February 1989, during the interim strategy, the Court held that *all* swaps were undertaken for a 'radically different' purpose:[76] these later swaps

[70] Hazell CA (n 16) 788 (Sir Stephen Brown P).
[71] ibid 781.
[72] ibid 784.
[73] ibid 788.
[74] ibid 781.
[75] ibid 790.
[76] ibid 794.

were lawful because the purpose was to mitigate losses which the public might be exposed to because of earlier trades.

Hazell in the House of Lords

In January 1991, the House of Lords upheld the auditor and council's appeal from the Court of Appeal, rejecting the banks' arguments in their entirety.[77] The House of Lords diverged sharply with the Court of Appeal's legal analysis and with its characterisation of the new derivative markets.

The overriding theme of their Lordships' analysis was that all swaps posed 'substantial risks' and were 'essentially speculative'[78] even when performing the narrow hedging function described by the Court of Appeal. Moreover, the House of Lords held, if Parliament had intended local authorities to have access to such products, it would have expressly provided for it within the 'detailed code'[79] governing local authorities' powers, as it had done in the case of building societies.[80] These themes are evident through four main elements of the House of Lords' interpretation of section 111(1).

First, the House of Lords held that swaps could not 'facilitate' the function of borrowing because a local authority which was encouraged to borrow on the assumption that it could rely on a successful swap in the future would be 'failing in its duty to act prudently in the interests of the ratepayers'.[81] Similarly, swaps were not 'conducive to' borrowing because local authorities should not be relying on them and should not see them as encouragement to borrow.[82] As Lord Ackner put it in his concurring opinion, swaps merely offered the 'hope of gain' and left the underlying debt 'wholly unmanaged'.[83]

Secondly, swaps were held not to be 'incidental' to borrowing. This was because swaps were a separate contract to any underlying debt, and could be entered into at a totally different time.[84] The authorities were held to show that being 'incidental' meant that an action was a 'potential necessity',[85] and not just 'convenient or desirable or profitable'.[86] Moreover, the question had to be decided not as a general matter but in light of the particular regime provided by Parliament in the borrowing provisions in Schedule 13 of the 1972 Act. Lord Templeman found this to be a 'comprehensive code'[87] which already allowed a local authority considerable scope to tailor its borrowing to suit its needs and address market volatility. Such a detailed scheme was not consistent with the existence of an incidental power to enter into swap transactions. The example was provided of unfavourable loan, which could be managed under Schedule 13 by repaying it or by renegotiating with the lender to replace one rate with another. The fact that this may be more expensive a route than entering a swap to manage the situation 'cannot render swap transactions legal.'[88] Parliament

[77] The discussion here does not address the banks' argument on the 'arcane point' that the powers of Hammersmith and Fulham Borough, as opposed to the Council, were not confined by the 1972 Act. Hazell HL (n 10) 43.
[78] Hazell HL (n 10) 46 (Lord Ackner).
[79] ibid 45 (Lord Ackner).
[80] ibid 35–36, referring to the Building Societies (Prescribed Contracts) Order 1986, SI 1986/2098 and the Building Societies (Prescribed Contracts) Order 1988 SI 1988/1344 which bestowed on building societies limited powers to enter into swaps.
[81] ibid 39 (Lord Templeman).
[82] ibid 29 (Lord Templeman).
[83] ibid 45.
[84] ibid 30 (Lord Templeman).
[85] *Small v Smith* (1884) 10 App Cas 119, 133 (Earl of Selborne LC), cited in ibid 30.
[86] ibid 31.
[87] ibid 33.
[88] ibid 33.

had simply not provided for local authorities to have access to swaps in addition to the detailed borrowing options set out in Schedule 13.

Thirdly, swaps could not be 'incidental' to a different function of debt management (as was held by the Court of Appeal). The House of Lords rejected the notion that debt management was a function of a local authority, finding that it was 'a phrase which has been coined in this case to describe the activities of a person who enters the swap market for the purpose of making profits which can be employed in the payment of interest on borrowings.'[89]

Fourthly, the House of Lords also rejected the banks' arguments that swap transactions were comparable to insurance and part of the prudent management of the council's business. Given the possibility of a party being 'out of the money', they were held to be 'more akin to gambling than insurance'.[90]

Swaps entered into as part of the interim strategy were not spared. They were held to 'suffer from the same stigma of being unlawful'[91] on the basis that the council had no power to enter into swap transactions regardless of whether they were part of the interim strategy or not.[92] Moreover, an ultra vires transaction could not provide the basis for an intra vires transaction.[93] There was no lawful underlying function for the latter.[94]

Accordingly, the House of Lords found for the auditor. It restored the Divisional Court's order under section 19(1) of the Local Government Finance Act 1982 that the swaps transactions were unlawful and that the accounts for the financial years 1987 and 1988 be rectified accordingly.

The impact of the decision

The impact of the House of Lords decision was dramatic at the time and is still keenly felt today. The immediate effect was to trigger over 200 claims concerning the losses faced by bank counterparties which had entered into now void swaps with local authorities across the UK.[95] The legal position on money paid out under a void contract was far from clear at the time of *Hazell*. As these claims worked their way through the courts, they did much to revive and to develop the law on unjust enrichment (which commentators in 1992 described as an 'area of English law many had thought was lost forever in the annals of legal history')[96] and to catalyse the accompanying academic debate.[97]

Ultimately, these claims were framed as common law claims for money had and received, in circumstances where there had been a total failure of consideration.[98] As a contemporary report on the House of Lords decision in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council*[99] put it, '[i]n another case dealing with void transactions by local authorities, the House of Lords has taken the opportunity to clarify the restitutionary remedies available'.[100] These did not, the House of Lords held in this

---

[89] ibid 34.
[90] ibid 35.
[91] ibid 47 (Lord Ackner).
[92] ibid 37.
[93] ibid 38.
[94] ibid 47.
[95] Stewart and Philips (n 59).
[96] ibid.
[97] As discussed in Ewan McKendrick, 'Local Authorities and Swaps: Undermining the Market?' in Ross Cranston (ed), *Making Commercial Law: Essays in Honour of Roy Goode* (Clarendon Press 1997).
[98] Described in *Haugesund* (n 7) [62].
[99] [1996] AC 669 (HL).
[100] Allen & Overy, 'Banking and Insolvency Law: Simple Interest only on void swap' (1996) 6 JIBFL 302.

majority decision, include compound interest, because the banks had a common law restitutionary claim. In 2010 Aikens LJ observed of *Hazell* that '[t]he resulting litigation also led to great developments in the English law of restitution, particularly at the hands of Lord Goff of Chieveley.'[101] These important developments represent the direct, substantive legacy of the Hammersmith litigation. However, less direct effects of *Hazell*, on the confidence and reputation of the English legal system, also need to be taken into account when assessing the lasting impact of the case.

The contemporary criticism of the House of Lords decision was fierce. Three lines of criticism set out in a 1991 article by Martin Loughlin remain persuasive.[102] The first is that Lord Templeman's account of the motivation for local authorities to enter into swaps and of the details of the transactions they may be entering into, was, with respect, an over-simplified one. For instance, a worked example in the judgment has the bank paying its local authority counterparty a fixed rate equivalent to the interest paid by the local authority on a loan rather than the fixed swap rate[103] and, as Loughlin points out, this affects later analysis in the judgment.[104] Secondly, there is a strong argument that the House of Lords' 'strict constructionist line'[105] was influenced by the fact that the technical questions in the case arose out of the outlier events at Hammersmith. As Loughlin put it, the House of Lords judgment was ultimately 'skewed by the circumstances of one exceptional authority's relationship to that market.'[106] Indeed, of the reported 77 local authorities which had entered into swap transactions, only 18 (other than the council) entered into more than five, and this group entered into only 400 or so transactions in total between 1987 and 1989. Furthermore, the management and supervision problems at Hammersmith were exceptional, as subsequently investigated by the independent Veeder inquiry, which published a final report running to 23 chapters.[107] This extreme set of facts looms over key parts of the House of Lords analysis. It is notable, for example, that a detailed discussion of the 'immense' scale of Hammersmith's swaps dealings is embedded at the heart of the section of Lord Templeman's analysis of the technical details of the swaps market and of various hypotheticals exploring why local authorities may wish to undertake these transactions.[108]

Thirdly, the House of Lords decision relied upon local authorities' ability to borrow in a flexible way from the Public Works Loan Board (PWLB) in order to conclude that Schedule 13 provided a complete code for local authorities' borrowing powers. As Lord Templeman explained, a local authority may borrow at a variable rate from the PWLB when interest rates are high, and once they fall, convert to a fixed rate if it wished to lock in the lower rate.[109] However, as the Court of Appeal identified, there were financial and practical disadvantages with this approach which did not apply to swaps, which could be taken up relatively cheaply, speedily and easily.[110] Loughlin details some of these disadvantages, which include the fact that local authorities could only repay the PWLB loans on certain

---

[101] *Haugesund* (n 7) [1].
[102] Loughlin (n 24).
[103] Hazell HL (n 10) 25. The fixed swap rate is the sum that a bank will pay in exchange for receiving a floating rate, and is a rate quoted by banks based on the maturity of the particular swap, their view of the market, their profit margin and perceived uncertainties associated with the floating rate. Conversely, the bank will quote a rate at which it is prepared to pay a variable rate. For further detail see David Murphy, *OTC derivatives: Bilateral trading and central clearing* (Palgrave Macmillan 2013) Chapter 1.
[104] Hazell HL (n 10) 26
[105] Loughlin (n 24) 591.
[106] ibid 593.
[107] Veeder Report (n 53). Ch 23 focuses on the 'grave errors of professional judgment' and management failures of particular individuals at the council.
[108] Hazell HL (n 10) 26-27.
[109] ibid 32.
[110] Hazell CA (n 16) 780.

dates, that they only had a certain quota of loans each year at a preferential rate from the PWLB, and the PWLB would not pay local authorities anything for cashing in loans at fixed rates below prevailing interest rates, in circumstances when interest rates were predicted to fall.[111] Against this background, the Court of Appeal's acceptance of swaps as a valid tool of interest rate risk managements seems the more realistic approach.

On this basis, *Hazell* may be seen as exemplifying both problems with ultra vires outlined in part 2 above, namely, the unpredictability of outcomes, particularly where novel products are involved, and the serious, unexpected impact upon bona fides third parties. This is part of the reason why the House of Lords decision is still so often cited as the epitome of legal risk. The other part of the explanation is that the market's response to *Hazell* has had as much of a legacy as the substance of decision itself.

The market reaction to the House of Lords decision was furious and has been unmatched since. This is not surprising. Notwithstanding its rather procedural origins, the case became a clash of world views, which the banks lost on all counts. A nascent financial sector, which was hitherto regarded as a perfectly legitimate one, had been, in the House of Lords' own words, tainted with the 'stigma of unlawfulness'.[112] One practitioner noted that the decision had been met with 'incredulity on the part of many in the banking world.'[113] Others proclaimed that the case 'turned the world … on its head'.[114] To this day, the case is still notorious.[115] In 2005, Professor Sir Roy Goode, writing in praise of the 'perceived predictability of English law and, more particularly, of decision-making by English judges', saw fit to warn that

> … every now and then uncertainty is created by new instruments or by unexpected judicial decisions., of which the most regrettable was that of the House of Lords in *Hazell* v *Hammersmith & Fulham London Borough Council*, overturning an eminently sensible and realistic ruling by the Court of Appeal.[116]

The contemporary criticisms of the House of Lords as uncommercial and out of touch with the markets made such a lasting impact because they erupted at a pivotal time for the City of London, coming in the immediate aftermath of the 'Big Bang' reforms of 1986. These reforms formed part of what historian David Kynsaton calls 'the financial services revolution of the 1980s'[117] during which the City was carving out its place in nascent global financial markets.[118] In the context of these political and industry efforts to bolster the City's international competitiveness, the damage to the international standing of English law and English courts was a matter of great commercial sensitivity. One market review of the 'cases of 1991'described the House of Lords decision in this way:

[111] Loughlin (n 24) 594.
[112] Hazell HL (n 10) 47 (Lord Ackner).
[113] Hubert Picarda QC, 'Interest Rate Swap Agreements in the Courts' (1996) 9 JIBFL 428.
[114] Stewart and Philips (n 59), 16 describing the impact of the first instance decision in *Hazell*.
[115] For example, Schuyler Henderson, 'Mahonia: Revisited in England, Part 1' (2005) 6 JIBFL 223, fn 10 refers to the definition of 'incidental' in the Hammersmith decision as 'incomprehensible to active practitioners in the financial markets'. The second part of the article, Schuyler Henderson, 'Mahonia: Revisited in England, Part 2' (2005) 7 JIBFL 265, fn 1, refers to the 'almost disastrous Hammersmith decision'. See also Tim Strong, 'Derailing derivatives' (2009) 11 JIBFL 666, referring to the House of Lords having 'notoriously' ruled that the swaps were ultra vires in *Hazell*.
[116] Roy Goode, 'Foreword to the First Edition' (August 2005) reproduced in Roger McCormick, *Legal Risk in the Financial Markets* (2nd edn, OUP 2010) ix.
[117] David Kynaston, *City of London: The History* (Vintage Books 2011) 567.
[118] ibid, especially ch 39. For a detailed analysis of the political and economic context linked to Hazell specifically, see McCormick (n 116) [14.20]–[14.30]. Overall, McCormick concludes of Hazell that '[i]t's place in history is earned not by its legal, but by its political significance.' ibid [14.01].

> The effect was devastating. In one fell swoop English law, upheld for so long as a model, was exposed. And the English courts yet again appeared ill-equipped to deal with the commercial realities of the fast-moving world of finance.[119]

European bank counterparties who had entered local authority swaps in good faith were particularly angered by the decision. One account in the Economist described French bankers storming out of a meeting complaining that 'Britain's legal standards had sunk to the level of Venezuela's'.[120] Some criticism went so far as to portray the case as an existential threat to the City of London. The head of legal services at Midland Montagu was quoted as remarking that the *Hazell* decision 'gave the French institutions an opportunity to shout out loud about the preference for using Paris over London'.[121]

Unsurprisingly, there were some immediate responses from regulators. In April 1991, The Bank of England set up of the Legal Risk Review Committee which produced a final report in October 1992. This report acknowledged that 'the swaps saga has damaged the reputation of English law' and concluded '[o]ne way or another, it is important to ensure that it does not happen again.'[122] On the Committee's recommendation, the Financial Law Panel ('FLP', now the Financial Markets Law Committee) was set up to monitor sources of legal risk in the financial markets.[123] The FLP included representatives from the City and from the legal sector. Mrs Justice Arden was a member when she wrote that the FLP was a 'market-driven form of solution'[124] to the risks revealed by *Hazell*, describing it as a method of bringing about commercial law reform.

Mrs Justice Arden was not the only member of the judiciary expressly to recognise the furore caused by *Hazell*. In *Westdeutsche Landesbank Girozentrale*, Lord Goff stated that

> I wish to record that [the House of Lords decision in *Hazell*] caused grave concern among financial institutions, and especially foreign banks, which had entered into such transactions with local authorities in good faith, with no idea that a rule as technical as the ultra vires doctrine might undermine what they saw as a perfectly legitimate commercial transaction.[125]

These various examples evidence a responsive relationship between the broader English legal system and the markets in the immediate aftermath of *Hazell*. One of the features of English law, cited in 2017 literature promoting the jurisdiction globally, was that it 'evolves to adapt to developing business practices and behaviour'.[126] The aftermath of *Hazell* is important for the substantive legal changes which flowed from the decision, but also as a moment in history where business left the legal establishment in little doubt that 'developments' were needed. The subsequent direction of English financial law, including decisions handed down as part of the second wave of local authority ultra vires cases, must be seen in this light.

---

[119] Stewart and Philips (n 59).
[120] The Economist, 'Rotten Boroughs' (26 January 1991) discussed in McKendrick (n 97) 215.
[121] Irene Dorner, quoted Stewart and Philips (n 59) 17.
[122] Final Report of the Legal Risk Review Committee (October 1992) [2.6], quoted in McKendrick (n 99) 218-219.
[123] For details of the work of the Financial Markets Law Committee see <http://www.fmlc.org >
The setting up of the Financial Law Panel is discussed in McKendrick (n 99) 218-219.
[124] Mrs Justice Arden, 'The Changing Face of Company Law' (1995) 5 JIBFL 210.
[125] *Westdeutsche Landesbank* (n 99) 680.
[126] Courts and Tribunals Judiciary, 'English Law, UK Courts and UK Legal Services after Brexit: The View beyond 2019' (2017), 3 <http://www.chba.org.uk/news/brexit-memo >

The second wave of ultra vires cases

Around the world in 30 years

Since *Hazell*, the issue of the capacity of local authorities to enter into derivatives transactions has arisen in the English courts on a regular basis. This may be thought of as a 'second wave' of local authority ultra vires cases. For example:

- *JP Morgan v BVG* involved a 'German public law institution… responsible for the provision and operation of the transport system of Berlin.'[127] In early 2007, BVG entered into a complex credit swap known as an 'independent collateral enhancement transaction'. BVG later argued that it understood it was reducing its own risk on cross-border leasing transactions it had entered into. In fact, one of the effects of the deal was that BVG agreed to provide JP Morgan with ten years of credit risk protection in respect of 150 companies, worth $220 million, for which JP Morgan paid BVG a fee of $7 million up front. The global financial crisis meant that various of these risks materialized, and JP Morgan claimed $112 million from BVG.[128]

- The background to *Haugesund Kommune v Depfa ACS Bank*, decided by the Court of Appeal in 2010, was that Norwegian local authorities entered into swaps in the early 2000s with a view to investing in a Credit Linked Note ('CLN'), intending to make a profit which would be used to improve local services or cut taxes. Instead, these CLN investments went 'disastrously wrong and the episode has been regarded as something of a scandal in Norway.'[129] Combined losses were around £26.7million.[130] The English litigation that resulted involved two Norwegian local authorities (Haugesund and Narvik), a Norwegian law firm and an Irish bank that was the subsidiary of a German parent.

- A significant derivatives case from 2012 concerned the Ceylon Petroleum Company, a statutory corporation set up under Ceylon Petroleum Corporation Act 1961 for the purpose of supplying crude oil and petroleum products to Sri Lanka. Between February 2007 and mid-2008, as oil prices were rising in an unprecedented way, CPC entered into about 30 derivatives transactions on the ISDA Master Agreement terms with three banks operating in Sri Lanka, in an 'attempt to protect itself from the rise in oil price'.[131] In fact, the oil price collapsed dramatically from late July 2008 and these derivatives proved extremely unfavourable for CPC. Litigation over two derivatives with Standard Chartered Bank proceeded to the Court of Appeal. The sum being claimed by the bank in this case was US$166 million. Parallel proceedings, involving CPC and another bank, had already been resolved by arbitration.[132]

---

[127] *JP Morgan v Berliner Verkehrsbetriebe (BVG) Anstalt des Öffentlichen Rechts* [2010] EWCA Civ 390, [2012] QB 176 (CA) [3] (Aikens LJ) (*BVG*).
[128] ibid [8].
[129] *Haugesund* (n 7) [2] (Aikens LJ).
[130] ibid [6].
[131] *Standard Chartered Bank* (n 8) [1] (Hamblen J).
[132] *Standard Chartered Bank v Ceylon Petroleum Corporation* [2012] EWCA Civ 1049 [9]-[12] discussing the arbitration between CPC and Citibank. Here, the tribunal accepted that CPC entered into these transactions beyond its capacity and therefore Citibank's claim failed.

- The ongoing saga of the Italian derivatives litigation involves international banks and numerous local authorities, including the Comune di Prato and the Italian Regional Authority for Piedmont. From 2006, Piedmont entered into derivatives on the ISDA Master Agreement terms as a strategy to manage interest rate risk on bonds that it had issued and to address other risks linked to its funding operations.[133] Prato signed an ISDA Master Agreement in November 2002 with Dexia, and subsequently entered into a series of interest rates swaps as a method of restructuring its worrying levels of debt, which totaled €111 million as at 31 December 2001.[134]

As Aikens LJ observed in *Haugesund*, '[i]t will be immediately obvious that none of the parties involved in this debacle has anything to do with England and Wales'.[135] These international cases are pulled into the English courts by a variety of factors, the most significant amongst which is the default drafting in the ISDA Master Agreement, which has come to dominate the global derivatives markets since the *Hazell* era.

Globalisation meets standardisation

Between *Hazell* and the outbreak of the global financial crisis in 2007, the OTC derivatives market changed beyond recognition. Innovative products found new ways to exploit the forward-looking quality of derivatives, (Gillian Tett memorably called them 'a dance with *time*'),[136] tapping into their enormous potential for structuring and complexity. Credit derivatives, for example, emerged very rapidly over the 1990s and ultimately came to play a part in the build-up to the global financial crisis, due to the opacity of these markets, and the way in which they exacerbated and concentrated risk. In the second half of 2007 alone, the notional amounts of outstanding CDS contracts increased by 36% to $58 trillion.[137] Meanwhile, more established products such as interest rate swaps grew into vast markets and are now routinely deployed by diverse end-users including companies, governments, supranationals, pension funds and insurance companies around the world.[138] Prompted by the central banks of the G-10 countries, the BIS started to collect official data on the global OTC derivatives market in 1998. At the end of June that year, the notional amount of outstanding contracts stood at $70 trillion.[139] By December 2007, notional amounts outstanding had soared to $596 trillion.[140]

It is safe to say that *Hazell* did not, for all the dire warnings from the banks, constrain the City of London's participation in this boom. In 2006, the fact that London was attracting certain types of financial services business at a faster rate than New York prompted Mayor Bloomberg and Senator Schumer to investigate. In their report, they noted business leaders' fears that New York risked being 'marginalized' as a centre for the global derivatives business. Tellingly, they warned that '[t]he more amenable and collaborative regulatory

---

[133] *Regione Piemonte v Dexia Crediop Spa* [2014] EWCA Civ 1298 [7].
[134] *Dexia Crediop S.P.A. v Comune di Prato* [2017] EWCA Civ 428 [1],[2].
[135] *Haugesund* (n 7) [7].
[136] Gillian Tett, *Fool's Gold* (Little, Brown 2009) 10. Emphasis in the original.
[137] Bank for International Settlements (BIS) Monetary and Economic Department, 'OTC derivatives market activity in the second half of 2007' (May 2008), 1.
[138] For a survey of end-users of derivatives, see ISDA, 'Research Study: Dispelling Myths, End-User Activity in OTC Derivatives' (April 2014) < https://www.isda.org/a/WPDDE/isda-dispelling-myths-final.pdf >
[139] BIS, 'The global OTC derivatives market at end-June 1998' (23 December 1998) 2 <http://www.bis.org/press/p981223.htm >
[140] ibid 1 and 7.

environment in London in particular makes businesses more comfortable about creating new derivative products and structures there than in the US.'[141]

A much-studied factor behind this dramatic evolution was the success of the standardised set of terms published by ISDA.[142] ISDA was founded in the mid-1980s, when eleven financial institutions began to co-operate on early swap documentation. Its subsequent history, ambitions and exponential membership growth is inextricably linked with the evolution of the OTC market.[143] Today, ISDA has 875 members from 68 countries.[144] Over the last thirty years it has become involved in significant regulatory, legislative and educational activities around the world, but the 'initial goal–and one of the key accomplishments of ISDA–has been the development, drafting, and promulgation of standard form documentation for the OTC derivatives industry.'[145]

The centerpiece of this suite of standard form documentation is the Master Agreement which designed to provide a single, clear and legally certain 'framework' contract between two parties, which sets out the basis on which they will subsequently enter into OTC derivatives with one another. The document is written and published by ISDA for its members' use, and versions have been published in 1987, 1992 and 2002. The Master Agreement is designed to be customised by using the accompanying documents also published by ISDA, including definitions booklets and a Credit Support Annex, in order to create the specific form of contractual architecture that the parties require. Critically, these documents are designed to be use in cross-border settings, and in this regard, they are bolstered by ISDA providing members with access to 'constantly updated'[146] legal opinions from dozens of jurisdictions.

It has been estimated that over 90% of OTC derivatives worldwide are now governed by the ISDA Master Agreement.[147] Most importantly for these purposes, section 13(b) of the contract provides for the jurisdiction of the courts of England and Wales, or New York, depending on the parties' choice of governing law as between English or New York law in Part 4(h) of the Schedule. The effect of choosing the English version of these two default options, as is currently the market norm within the EU and also elsewhere, is to pull into this jurisdiction dozens of disputes involving global derivatives transactions. This includes each of the cases described at the beginning of this part of the article.[148]

The evolution of the derivatives market over the last thirty years also explains the distinct features of the second wave of derivatives cases before the English courts, which significantly diverge from the *Hazell* era. Most importantly, because derivatives disputes before the English courts now almost always have an international dimension, they often involve preliminary disputes about jurisdiction. This is reflected in the very first paragraph of

[141] Michael Bloomberg and Charles Schumer, 'Sustaining New York's and the US's Global Financial Services' (2006) 13 <http://www.nyc.gov/html/om/pdf/ny_report_final.pdf >

[142] See, eg, Frank Partnoy, 'The Timing and Source of Regulation' (2014) 37 Seattle University Law Review 421, 428–432, discussing the effect of ISDA's documentation which he describes as an example of 'privately sourced regulation' (432); Riles (n 6).

[143] For an account of the history of ISDA, see Sean Flanagan, 'The Rise of a Trade Association: Group Interactions within the International Swaps and Derivatives Association' (2011) 6 Harvard Negotiation Law Review 211. The early history of the organisation is found at 234–238.

[144] ISDA, 'About ISDA' <https://www.isda.org/about-isda/>

[145] Flanagan (n 143) 229.

[146] ibid 252.

[147] Schuyler Henderson, *Henderson on Derivatives* (2nd edn, LexisNexis UK 2010) 203; evidence provided by ISDA, cited in *Lomas & Ors v JFB Firth Rixson* [2010] EWHC 3372, [2011] 2 BCLC 120 [5].

[148] Though note that Brexit may affect parties' choices of law and forum in the future. At the time of writing, ISDA is 'looking to add' extra options under the Master Agreement: derivatiViews: From the Executive office of ISDA, 'Brexit and the ISDA Master Agreement' (8 January 2018) <https://isda.derivativiews.org/2018/01/08/brexit-and-the-isda-master-agreement/ >

the Court of Appeal decision in *JP Morgan v Berliner Verkehrsbetriebe (BVG) Anstalt des Öffentlichen Rechts*, which states that

> Credit default swap arrangements are giving rise to litigation again. As is so often the case in commercial disputes the first battle is over jurisdiction.[149]

The international dimension therefore complicates the issues involved in modern ultra vires cases arising in the derivatives market. In practice, it helps to generate new legal issues around jurisdiction and applicable law, while at the same time complicating traditional ones, relating to the definition of capacity and to the nature of any resulting claims.

Ultra Vires in Practice

Applicable law

In the second wave of local authority ultra vires cases, the interaction between ultra vires and conflicts of law has generated novel problems for the English courts. One such issue concerned the definition of capacity for the purpose of the relevant conflicts of law rule.

Determining the law which applies to a dispute about the binding nature of the decisions of a local authority falls outside the Rome Convention[150] and is therefore governed by the English common law. In *Haugesund*, all parties agreed that the relevant rule was Dicey, Morris & Collins, rule 162, which states that:

> (1) The **capacity** of a corporation to enter into any legal transaction is governed both by the constitution of the corporation and by the law of the country which governs the transaction in question;
> (2) All matters concerning the constitution of a corporation are governed by the law of the place of incorporation.[151]

On this basis, the question of whether Norwegian kommunes had capacity to enter the disputed swap contracts was governed by Norwegian law, pursuant to which the kommunes were constituted. However, the meaning of 'capacity' for this purpose was a novel issue when it arose for determination in *Haugesund,* which was described by Etherton LJ as coming down to 'a matter of policy'.[152] Matters were further complicated in this case by the fact that there was little guidance in Norwegian law on the underlying issues.[153]

With the assistance of expert witnesses, Tomlinson J found that Norwegian law approached these matters very differently to English law. Unlike an English local authorities, Norwegian kommunes have several different sources of power, sharing some of the powers of natural persons as well as having powers granted to them by legislation.[154] Put simply, Norwegian law regarded kommunes as autonomous entities which started with a type of general competence which was then limited by subsequent legislation. Moreover, the judge

[149] *BVG* (n 127) [1] (Aikens LJ).
[150] Convention 80/934/EEC on the law applicable to contractual obligations opened for signature in Rome on 19 June 1980 (OJ 1980 L266, p 1) (the 'Rome Convention'), given force in the UK by the Contracts (Applicable Law) Act 1990.
[151] Cited in *Haugesund* (n 7) [27]. This author's emphasis.
[152] ibid [133] (Etherton LJ).
[153] *Haugesund Kommune v Depfa ACS Bank* [2009] EWHC 2227 (Comm) at [122].
[154] ibid [111].

found that Norwegian law did not in fact address the extent of the capacity of local authorities, nor did it focus on the validity or invalidity of the transactions but was primarily interested in the binding nature of the transactions for third parties.[155] Importantly, the act of entering a contract was found to be reviewable rather than automatically invalid if done in transgression of a kommune's powers under the relevant statute.[156] For these reasons, it was 'not easy to transpose Norwegian legal theory into English terminology and in particular not into the language of capacity.'[157]

Nonetheless, Tomlinson J found that under the relevant statutory regime, the Norwegian kommunes lacked substantive powers under Norwegian law to enter the contracts, and that this equated to a lack of 'capacity' under English law. It was common ground that the consequences of a lack of capacity were then a matter to be decided under the law of the transaction, ie, English law. As a result, the contracts were held to be void. This was even though under Norwegian private law would have treated them as valid and enforceable.

On appeal, counsel for the bank argued that 'capacity' for the purpose of the Dicey rule should be read narrowly so that it referred to 'capacity' strictly defined under English law, as linked to nullity, but not abuse of powers. The distinction was demonstrated by reference to *Rolled Steel Products*[158] which held that a contract entered into beyond the capacity of the company is wholly void, whether or not the third party had notice but where the contract is within the capacity of the company but in excess or abuse of powers, the position of the third party will depend on whether or not he had notice that the transaction was compromised. Under this approach, the bank argued, the kommunes had capacity as understood in the narrow, English sense even though their powers were limited by the Norwegian statute. For that reason, the bank submitted, the contracts should be regarded as valid.

The Court of Appeal split in this point, with the majority deciding that there should be an expressly 'internationalist' reading of the word 'capacity' and of the word 'constitution' for the purposes of Dicey's rule. As a result, 'capacity' in this context should take into account broad matters relating capacity, powers and validity under local law.[159] The majority held that it was relevant that the rule was inevitably intended to apply to non-English corporations, and therefore 'assumes that the legal concept of "capacity" has a commonly understood content and significance so far as concerns non-English corporations.'[160] The majority also held that it would be risking 'legal parochialism' to assume that the term in Dicey's rule, though a rule of English common law, should be read narrowly in line with English common law concepts.[161] For the same reason the word 'constitution' was also given an 'broad, internationalist' meaning by the majority, and held not simply to extend to the equivalent of a English royal charter or memorandum and articles of association of a company.[162] The broader definition included all potential sources of power including the relevant statutes and other 'rules of law' of the country of incorporation.[163].

---

[155] ibid [114]

[156] ibid [109]. The relevant statute was the Norwegian Local Government Act 1992, s 50 which restricted the circumstances in which a municipality may borrow money, reproduced ibid [10].

[157] ibid [109] (Tomlinson J). Discussed at *Haugesund* (n 7) [36].

[158] (n 11). Discussed in *Haugesund* (n 7) [34].

[159] ibid [44].

[160] ibid [40] (Aikens LJ).

[161] ibid [42].

[162] ibid [48].

[163] ibid [48].

Etherton LJ disagreed with this part of the majority's decision finding it a 'wholly artificial' approach which led to a 'bizarre result'.[164] In his view, 'capacity' for the purpose of Dicey's rule should be given the narrow meaning it had under English law.[165] Accordingly, there would not be a lack of capacity if a decision merely exceeded an entity's powers, and where a decision was not automatically void.

In subsequent cases, litigants have indicated their intention to challenge this part of *Haugesund*.[166] It has, however, been pointed out that the majority's approach is persuasive because the court should characterise the issue as argued before the court, rather than the foreign rule of law, and because Dicey's rule was intended to be pragmatic rather than restricted to foreign law which corresponded exactly with the English understanding of 'capacity'.[167] Looking more broadly, the majority's approach is also persuasive in the sense that it is consistent with the expressly internationalist and pragmatic approach to novel policy questions seen elsewhere in modern derivatives market cases.

Purpose

Once questions of jurisdiction and applicable law have been settled, it is for the court to evaluate if the particular contract (or contracts) are within the capacity of the local authority as it is defined by local law. In *Haugesund*, the starting point was whether the swaps were loans under the relevant Norwegian statute. Usually, this question turns on the purpose to which derivatives were put, but this important stage in the court's analysis has been complicated by the nature of modern derivatives products and confusion around the terms 'hedging' and 'speculation'.

Categorising derivatives by their purpose is a process which starts from scratch in each case, as it has been held to be irrelevant how the transactions would be regarded in other contexts, including under accounting principles[168] or under definitions in financial services regulation.[169] It has been said that the court should undertake this as an objective exercise, so that it does not matter what purpose the parties say that the deal was for.[170] However, as the Court of Appeal in *Standard Chartered* pointed out, in the absence of a consistent definition of hedging or speculation, it is difficult to apply these terms 'solely objectively'.[171]

In *Standard Chartered,* the Court of Appeal challenged the central idea that products may be neatly categorized at all, and stated that 'the question of hedging and speculation is, at any rate, in the context of an issue of capacity, a false question'.[172] Given the numerous problems around this exercise when it is conducted in the context of highly complex transactions, this statement seems more than justified. As the court pointed out in *Vestia*, in the right circumstances, any derivative could potentially be a hedging product.[173] This may

[164] ibid [144].
[165] ibid.
[166] *Credit Suisse v Stichting Vestia Groep* [2014] EWHC 3103, [2015] Bus LR D5, [185] (*Vestia*)
[167] Adrian Briggs and James Edelman, 'Restitution and not-so-local authority swaps' (2010) 126 LQR 500, 501-502, referencing the 'pragmatic, outward looking approach to characterisation recently restated in *Macmillan Inc v Bishopsgate Investment Trust Plc (No. 3)* [1996] 1 W.L.R. 387 CA and in *Raiffeisen Zentralbank Osterreich AG v Five Star General Trading LLC* [2001] EWCA Civ 68; [2001] Q.B. 825.'
[168] *Vestia* (n 166) [227].
[169] *Haugesund* (n 7) [16].
[170] *Vestia* (n 166) [225].
[171] *Standard Chartered Bank* (n 132) [9].
[172] ibid [22] (Moore-Bick LJ).
[173] *Vestia* (n 166) [224].

depend on external factors,[174] any broader hedging strategy,[175] or on taking into account how products work in combination with each other.[176]

Overall, the tendency in some cases and commentary to use 'hedging' as a shorthand for 'valid under the applicable rules providing for capacity' is not helpful for four main reasons: it risks over-simplifying the provisions of the applicable law governing the local authority's capacity; it attributes too much weight to labels which are themselves divisive terms, thereby opening up new questions for experts and for the court; the terms are difficult to apply to the complex derivatives which are the most likely to give rise to these disputes in the first place; and most importantly, this exercise distracts from the proper task in hand, which is evaluating whether the contracts are within the capacity of the user or not.

In this context, it should be regarded as a positive development that a recent first instance decision involving Portuguese transport companies followed a 'capacity-led' approach, rather than attempting to define the purpose of particular products.[177] The transport companies had argued that they did not have the capacity to enter into speculative derivatives, but the court declined to analyse the matter in this way. Notably, this part of the judge's decision was not appealed,[178] unlike the equivalent part of the first instance decision in *Standard Chartered*.

For these reasons, litigants in ultra vires cases should avoid characterising the applicable legal framework in terms of hedging and speculation, and where possible, the courts should continue to decline the invitation to evaluate the limits of a party's capacity in this unhelpful way. Moreover, regulators should take these cases as a lesson to avoid embedding the terms 'hedging' and 'speculating' in financial markets legislation without precisely defining them in each context.[179]

Consequences

It is accepted across these cases that the consequences of any lack of capacity (broadly and 'internationally' defined, according to *Haugesund*) are 'to be determined by the putative applicable law of the contract, that is English private law.'[180] In *Haugesund*, this analysis was accepted by both parties, and held to be implicit both in the Dicey rule and logically correct, as otherwise there would be 'no scope for involvement of the putative applicable law of the contract.'[181] This, however, opens the door for the traditional, unmitigated version of the

---

[174] For example, in *Vestia*, Transactions 1 and 2 (combined) provided protection against rising interest rates after 2033 but not if rates exceeded 4.5%.

[175] For example, it could mean that contracts which cancel or dispose of individual hedging positions are actually part of a broader hedging strategy, as discussed in *Vestia* (n 172) [223].

[176] As in Transaction 1 and 2 in *Vestia*, which comprised a swap and a swaption (which in fact complicated the question of whether Transaction 1 was a hedge).

[177] *Banco Santander Totta* (n 3) [281].

[178] *Banco Santander Totta SA v Companhia De Carris De Ferro De Lisboa SA* [2016] EWCA Civ 1267, [2017] 1 WLR 1323.

[179] As they have done, for example, under Regulation (EU) No. 648/2012 on OTC derivatives, central counterparties and trade repositories. Under this Regulation, non-financial counterparties are only subject to the clearing mandate if their derivatives business exceeds certain thresholds. Derivatives count towards this threshold if they 'are not objectively measureable as reducing risks directly relating to the commercial activity or treasury financing activity of the non-financial counterparty or of that group.' (Article 10(3)). This definition has been expanded upon in Commission Delegated Regulation (EU) No 149/2013 of 19 December 2012, Article 10. This provides that contracts will meet the EMIR definition if they fulfil one of three criteria, the third of which is that they qualify as 'hedging contracts' which are defined by reference to the International Financial Reporting Standards (IFRS). The term 'hedging' is not otherwise mentioned in this definition.

[180] *Haugesund* (n 7) [60] (Aikens LJ).

[181] ibid.

English doctrine of ultra vires. The harsh consequences of this doctrine and sizeable sums at stake have led banks to come up with various arguments trying to squeeze their counterparties within some of the recent legislative measures designed to reform the law in this area.

For example, a creative, though ultimately unsuccessful, argument in *Vestia* referenced First Council Directive on company law of March 1968.[182] One of the objectives of this Directive was

> to ensure certainty in the law as regards relations between the company and third parties, and also between members, to limit the cases in which nullity can arise and the retroactive effect of a declaration of nullity …[183]

The argument put forward in this case was that the relevant sections of the Companies Act 2006 should be interpreted to apply to equivalent EU entities and protect them from the English rule on ultra vires.[184] The problem with this argument in the context of Vestia was that the Directive itself did not cover the 'stichting' form of association, but only BV and NV (companies). There was no basis, therefore, to extend the coverage of the English Companies Act 2006 to a Dutch stichting. The same argument was raised in the later case of *Banco Santander Totta SA v Companhia De Carris De Ferro De Lisboa SA*, but as these swaps had already been held to be within the capacity of the public sector Portuguese companies, it did not have to be decided on that occasion.[185]

Thus, at present, where court concludes that an entity lacks 'capacity', it means that swaps will be held to be void under English law, even if they would be valid under domestic law (the case in *Haugesund*, but not in *Vestia*) and even if the same act if done by an English entity would also be valid. As a practical matter, this leaves bank counterparties to pursue a variety of remedial options. To date, as well as claims in restitution, these have included novel arguments that the representations in the over-arching ISDA Master Agreement remain valid and provide a basis for damages[186] and attempts to recover losses from their legal advisors.[187]

At this final stage, the foreign dimension to the second wave of local authority ultra vires cases once again generates unprecedented questions. Several arose in *Haugesund*, including the councils' argument that a claim for restitution would be contrary to Norwegian public policy.[188] The question of whether an English court considering an English law claim for restitution should take into account foreign public policy was described by the Court of Appeal as unprecedented. As a result, the Court sought to reason 'from first principle', ultimately holding that, subject to English public policy,[189] it would be 'logical and

[182] First Council Directive 68/151/EEC on co-ordination of safeguards which, for the protection of the interests of members and others, are required by Member States of companies within the meaning of the second paragraph of Article 58 of the Treaty, with a view to making such safeguards equivalent throughout the Community [1968] OJ L65, updated by Directive 2009/101/EC on coordination of safeguards which, for the protection of the interests of members and third parties, are required by Member States of companies within the meaning of the second paragraph of Article 48 of the Treaty, with a view to making such safeguards equivalent [2009] OJ L258.
[183] First Council Directive 68/151/EEC (n 189) Recital.
[184] Based on the principle from Case C-106/89 *Marleasing SA v La Comercial Internacional de Alimentacion SA* [1995] ECR I-04135.
[185] *Banco Santander Totta* (n 3) [341].
[186] *Vestia* (n 166).
[187] *Haugesund Kommune v Depfa ACS Bank (Wikborg Rein & Co, Part 20 Defendant) (No 2)* [2011] EWCA Civ 33, [2012] 1 All ER (Comm) 65.
[188] For further discussion of the restitution elements of this case, see Briggs and Edelman (n 167).
[189] *Haugesund* (n 7) [99] (Aikens LJ).

consistent' to consider foreign statute at this point, given that it had taken account of the same statute when deciding the issue of capacity in the first place.[190] However, the Court of Appeal unanimously upheld the judge's decision that nothing under this statute would bar recovery of money paid under a contract which was invalid.[191] The councils therefore failed in this novel part of their defence, turning their success on the issue of capacity into a Pyrrhic victory.

Conclusion

At the beginning of the majority decision in *Haugesund*, Aikens LJ remarked that '[h]istory repeats itself, at least with variations.'[192] This article has investigated the variations over thirty years of local authority ultra vires cases. It has found that, like the markets themselves, these cases have become more complex and more international since the *Hazell* era. This explains why, even though English law has significantly circumscribed the ultra vires doctrine, a mutation of the original problem continues to generate novel and difficult legal questions before the English courts.

The legal rules which have emerged over the course of the second wave of ultra vires cases have been shown to have an internationalist, market-minded and pragmatic character. This contrasts sharply with the approach of the House of Lords in *Hazell* which found early swaps tainted with the 'stigma of unlawfulness'. This evolution has been linked to two factors. First, it has been linked to the fierce criticism that *Hazell* provoked at a pivotal moment in history. From this perspective, the most important legacy of *Hazell* was not any damage to the City of London or to the foundations of the derivatives market (despite the colourful claims in aftermath of the decision) but rather the timing and the extent of the market response which the House of Lords decision triggered. For this reason, *Hazell* is an important part of understanding where we are today. Secondly, this evolution has been explained in terms of structural changes in the prevailing markets, which have seen the English courts become an embedded part of the contractual architecture dominating the OTC derivatives markets.

Thirty years on from Hammersmith and Fulham London Borough Council's fateful scaling-up of its derivatives activities, the law around the capacity of local authorities has grown more intensely complex. Taking a long view shows that this area of law now contains a difficult internal contradiction. On the one hand, in the cases described in the second half of this article we may still observe the traditional and largely discredited English doctrine of ultra vires, with all the associated risks of unpredictable decisions for parties who deal in good faith. On the other hand, these recent cases also offer clear proof of the responsiveness, pragmatism and international outlook of the English courts, armed as they are with the unforgettable lessons of *Hazell*. Clearly, this history is not over yet.

[190] ibid [100].
[191] Etherton LJ agreed with this part of the majority's decision. *Haugesund* (n 7) [132].
[192] ibid [1].