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Interest rate swaps and "an elastic, factually sensitive duty"
***Property Alliance Group Ltd v Royal Bank of Scotland Plc* [2018] 1 W.L.R. 3529**

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Introduction

Property Alliance Group Ltd is the latest Court of Appeal decision on the scope of the legal duties for economic loss owed by financial institutions towards commercial clients who enter into interest rate swaps. The relationship between bank and customer is ordinarily that of debtor and creditor, with no obligation to advise and no common law or fiduciary duties of care. "Assumption of responsibility" and a duty to explain fully has been the route that claimants have taken to try to establish a duty of care, but Property Alliance Group Ltd provides another illustration of the uphill struggle such claims have faced.

The facts

The claimant, PAG, was a property investment and development business with a portfolio of industrial sites, offices and retail and leisure properties. Its managing director and majority shareholder, DR, made all major decisions, and EW was the finance director. PAG received advice from consultants on banking matters, including interest rate hedging. RBS was PAG's principal source of commercial banking facilities for "development facilities" (short-term borrowing to develop properties and referenced to a margin over Bank of England base rate) and "investment facilities" (finance property investment assets and reference to a margin over the London inter-bank offered rate (LIBOR)). Under each loan facility agreement RBS required PAG to enter into and maintain an interest rate hedging agreement to ensure that PAG would be protected against increases in interest rates that might otherwise undermine PAG's ability to pay the interest due on its outstanding loans from RBS. PAG would be liable to pay a "break cost" if interest rates declined or would stand to receive money if interest rates went up. In essence, RBS would gain if interest rates fell and PAG would gain if they rose. RBS made its own internal estimate of the cost to PAG of breaking the swaps during their life on a "worst case" basis and worked examples of how much the break costs could be in different scenarios, including if interest rates moved significantly lower. Although PAG was aware of the potential for break costs to vary according to market conditions, it did not ask for any information about those costs.

At the time of the swaps, 2004–2008, the break costs were modest, between £42,000 and £110,000. Interest rates fell after the global financial crisis and remained low, as did the relevant LIBOR to which the swaps were tied, so that the rates of interest PAG paid under the swaps was far greater than the rates it received. In 2011 PAG terminated the swaps and incurred break costs of £8.261m. It then raised proceedings against RBS for rescission of the swaps and/or damages on the ground of misrepresentation, misstatement and breach of contract (its claims in relation to LIBOR manipulation was also dismissed but is not the subject of this article). PAG claimed that RBS was liable in tort for negligent misstatement as a result of its failure to provide PAG with information about potential break costs. RBS was in breach of duty in tort in failing to provide PAG prior to each of the swap contracts with either RBS's internal estimate of the cost to PAG of breaking the swaps during their life on a "worst case" basis or worked examples of how much the break costs could be in different scenarios, including if interest rates moved significantly lower.

The jurisprudential context

The general approach of the courts to the question of whether a duty of care arises in respect of economic loss has been to "identify organising concepts to express value judgments about whether a duty exists in the circumstances of an individual case" (Beatson LJ in *CGL Group Ltd v Royal Bank of Scotland Plc* [2018] 1 W.L.R. 2137 at [59]). The courts apply three complementary tests or approaches that usually lead to the same answer and that should be used as cross-checks on each other: (i) whether the defendant assumed responsibility to the claimant (the test was applied objectively and the court was looking for a conscious, considered and deliberate assumption per Lord Walker in *Customs and Excise Commissioners v Barclays Bank Plc* [2007] 1 A.C. 181 at [73]); (ii) the *Caparo* threefold test of whether the loss was a foreseeable consequence of the defendant's action or inaction, the relationship was sufficiently proximate and it would be fair, just and reasonable to impose the duty; and (iii) whether the addition to existing categories of duty would be incremental rather than indefinable (of little value as a test in itself, and only helpful when used in combination with a test or principle that identifies the legally significant features of a situation, Lord Bingham in *Customs and Excise Commissioners* at [7]). The result is a "broad and open-textured framework" to assess the detailed circumstances of the particular case and the particular relationship between the parties in the context of their legal and factual situation as a whole (*Customs and Excise Commissioners* at [8]).

In *Bankers Trust International Plc v PT Dharmala Sakti Sejahtera (No.2)* [1996] C.L.C. 518, where the bank had volunteered an explanation to its customer that the proposed substitute swap would improve the customer's risk exposure, Mance J said, at 533, that

> "a bank negotiating and contracting with another party owes in the first place no duty to explain the nature or effect of the proposed arrangement to the other party. However, if the bank does give an explanation or tender advice, then it owes a duty to give that explanation or tender that advice fully, accurately and properly. How far that duty goes must once again depend on the precise nature of the circumstances or advice which is tendered".

In that case he held, at 573, that the duty not to misstate facts obliged the bank to present the financial implications of the proposal by a properly constituted graph and letter that presented the downside and upside of the proposal in a balanced fashion.

In *Crestsign Ltd v National Westminster Bank Plc* [2015] 2 All E.R. (Comm) 133, the bank had accepted that it owed a duty not to make a negligent misstatement in relation to a loan agreement it made with the claimant. The claimant argued that, in fact, the bank owed a common law duty to take reasonable care when providing information to ensure it was both accurate and fit for the purpose for which it was provided, namely to enable the claimant to make a decision on an informed basis. The claimant described it as a mezzanine duty, less onerous than the duty in relation to giving advice but more onerous than the bare duty not to misstate, derived from Mance J's dicta in *Bankers Trust* as to a full, accurate and proper explanation. The judge in that case accepted that he was bound by Mance J's dicta.

First Instance [2016] EWHC 3342 (Ch)
PAG accepted that RBS was never under a general advisory duty in relation to the swaps but argued that, by volunteering information and explanation as to their nature and effect, it was under a duty to take care that the information and explanations did not mislead PAG as a result of what was omitted or not said and that the information and explanations were full, accurate, proper and adequate, in particular in relation to the scale or magnitude of break costs in the event of termination. RBS had breached that duty by failing to provide PAG with its internal estimate of the potential cost of breaking the swaps. The foundation of that case was the dicta of Mance J in *Bankers Trust* at 533.

Asplin J dismissed the claims, holding that there was no duty to reveal the extent of the break costs and that PAG had not entered into the swaps as a result of that information having been withheld. Equally, she found that RBS had not provided any inaccurate information. PAG appealed, arguing that the judge had fundamentally misunderstood that its case was that RBS was liable for breach of the classic *Hedley Byrne* duty not to misstate, by giving only a partial and so misleading and inaccurate explanation; in the words of Mance J in *Bankers Trust*,

> "if a bank does give an explanation or tender advice then it owes a duty to give that explanation or tender that advice fully, accurately and properly".

The Court of Appeal (Sir Terence Etherton, Longmore and Newey LJJ)
At [66] the court confirmed that the starting point was that a bank negotiating and contracting with another party owed no duty to explain the nature or effect of the proposed arrangement. The duty to advise fully, accurately and properly, if an explanation or advice is given, covered a range of possible factual situations so that the precise nature of the circumstances was crucial; the duty not carelessly to misstate was "an elastic duty that is factually sensitive", [64]. Noting that PAG's case was founded on *Bankers Trust*, the court noted that its circumstances were different because the bank had explained that the swap would improve the customer's risk exposure, which was not the situation in *Property Alliance Group Ltd*.

The court added that the expression "mezzanine" duty or intermediate duty was "best avoided". It appeared to reflect the notion that there was a continuous spectrum of duty, stretching from not misleading to full advice. Concentration should instead be on "the responsibility assumed in the particular factual context as regards the particular transaction or relationship in issue". The court noted that a bank's duty might, depending on the context, extend to correcting any obvious misunderstandings communicated by the customer and answering any reasonable questions the customer might ask about the products about which the bank had volunteered information, [67].

The court, at [72], did not accept that RBS had breached its *Hedley Byrne* duty by failing to provide a full and proper explanation and omitting to disclose the potential size of the cost of breaking the swaps. PAG had been made fully aware that breaking the swaps would have adverse financial consequences and that the size of those consequences would depend on the interest rates at the time. There had been no error in the way that RBS had explained the terms of the swap, including when break costs might be incurred and how they would be calculated. The court added at [77] that none of the three tests for tortious liability were satisfied to establish a duty to disclose break costs; there had been no assumption of responsibility for the disclosure by RBS and no basis for holding it was fair, just or reasonable to impose the duty. It saw no basis for setting aside the judge's conclusion that PAG did not enter into the swaps as a result of non-disclosure of the break cost scenarios. Although it was aware of the potential for break costs it never asked RBS for its own scenarios.

Conclusion

The court's findings that no duty was owed and that PAG did not enter into the swaps as a result of the non-disclosure appear to confuse two different concepts. However, the decision again emphasises that reliance on helpful dicta will not overcome a proper analysis of the particular facts.