

Hazell v. Council of the London Borough of Hammersmith and Fulham and others**

On January 24, 1991, the House of Lords of England rendered its decision in *Hazell v. Council of the London Borough of Hammersmith and Fulham and others*.¹ This case will surely be considered a milestone in the development of the law applicable to swap² transactions. The swap, a relatively young financial tool, continues to be a largely unregulated transaction. Moreover, little jurisprudence can be found that addresses the legality of swaps or any of the other matters relevant to the enforcement of swaps. This legal void explains the anticipation felt by those waiting for the House of Lords' judgment and the current excitement, disappointment, and discussion about the decision.

Persons dealing regularly in the swap market are preoccupied with the reasons and implications of the judgment. To the shock of those dealers, and to the dismay of the banks arguing the case, the House of Lords unanimously held that the swap transactions entered into by the Hammersmith and Fulham Council (the Council) were ultra vires of the Council and thus contrary to law. As a direct consequence of this decision, lawyers who advise on the matter and active traders face particular concerns.

*Phillips & Vineberg, of Montreal, Québec (Goodman Freeman Phillips & Vineberg, nationally). Member of Québec and New York bars.

**The author's analysis of this case for Canadian readers appears in 7 BANKING & FIN. L. REV. 123 (1991-92).

1. 1991 All E.R. 545, [1991] 2 W.L.R. 372.

2. For those not familiar with the subject, a swap is basically an exchange between two parties of a series of cash flows determined, for example, in relation to fixed and floating interest rates, which at the time the parties enter the swap contract are, as calculated by the parties, equal on a discounted time value basis. Further helpful references include Pappe, *The Ins and Outs of Swap Transactions*, 15 CAN. BUS. L.J. 158 (1989); Barken, *Hedging Techniques for Interest Rate and Currency Risks*, 3 BANKING & FIN. L. REV. 37 (1988-89); Evans, *The Banks Under Developments in United Kingdom Case*, 6 BANKING & FIN. L. REV. 151 (1991); Antl, *Markets and Techniques*, in MANAGEMENT OF INTEREST RATE RISK (B. Antl ed. 1988); and Rogers, Cunningham & Pickle, *Interest Rate and Currency Swaps and Related Transactions* (Jan. 6, 1990) (paper by members of the law firm of Cravath, Swaine & Moore).

An understanding of the facts that the House of Lords had before it when it rendered its decision is essential to an appreciation of the implications of this case.

I. The Facts

Beginning in December 1983 the Council entered numerous swap transactions.³ By March 31, 1989, the Council had entered 592 swap transactions, 297 of which, at the time of the appeal, were still outstanding. The Law Lords noted that the notional principal⁴ involved in the swap transactions entered into by the Council totalled approximately £6,052 million. As of March 31, 1989, the outstanding transactions involved notional principal totaling approximately £2,996 million.

The House of Lords adopted a statement made in the judgment of the Divisional Court⁵ to describe the swaps entered into by the Council:

[A]n agreement between two parties by which each agrees to pay the other on a specified date or dates an amount calculated by reference to the interest which would have accrued over a given period on the same notional principal sum assuming different rates of interest are payable in each case. For example, one rate may be fixed at 10 per cent, and the other rate may be equivalent to the six-month London Interbank Offered Rate ("LIBOR"). If the LIBOR rate over the period of the swap is higher than 10 per cent, then the party agreeing to receive "interest" in accordance with LIBOR will receive more than the party entitled to receive the 10 per cent. Normally neither party will in fact pay the sums which it has agreed to pay over the period of the swap but instead will make a settlement on a "net payment basis" under which the party owing the greater amount on any day simply pays the difference between the two amounts due to the other.⁶

The Law Lords were of the view that the swap transactions in question were not carried out to enable the Council to borrow money, or even to enable the Council to choose to borrow at a fixed interest rate rather than at a variable rate, or vice versa. Instead, the Law Lords believed that the Council was participating in swap transactions in the hope that by successfully forecasting movements in interest rates it could generate profits that would be used to reduce the burden of interest payable on its borrowings.⁷

The district auditor, Mr. Hazell (the appellant before the House of Lords), discovered that the Council was participating in swaps. He argued that participation by the Council in swaps was unlawful, and he took the Council to court

3. What the Council was doing was not entirely innovative or novel. Hazell, the district auditor, had come to the conclusion that 77 local authorities out of 450 principal local authorities entered into approximately 400 swap transactions within a two-year period ending in 1989.

4. 1991 All E.R. at 552. In deriving swap transactions the concept of "notional principal" is important. It is often used as a measure of the "size" of the deal.

5. [1990] 2 W.L.R. 17, 52.

6. 1991 All E.R. at 550.

7. *Id.*

to make his point. Although the Council was the respondent in the case and a party to the litigation throughout, the House of Lords mentioned that the Council felt obliged to support the auditor by agreeing that the swap transactions entered into by it were unlawful.⁸ (Perhaps the Council's change of opinion regarding the legality of the swap transactions was motivated by the possibility that it would, should the transactions be held to have been *ultra vires*, save some money.) As a result, the banks with whom the Council had entered many swap contracts were, after joining the proceedings, left to defend the legality of the deals.

II. The Issue

Simply stated, the issue in the case was not whether swap transactions in general were illegal; rather, the issue was whether the Council "possessed power to enter into any swap contract."⁹ To answer this question the House of Lords had to identify and interpret the Council's source of authority and power, the Local Government Act 1972 (the Act). Was the Council acting within permitted limits? Was a swap transaction "calculated to facilitate, or conducive or incidental to" borrowing?¹⁰ Although the House of Lords made passing reference to the speculative and risky business of swaps, it did not debate whether swap contracts were gaming or gambling activities or otherwise illegal or subject to other laws, such as insurance laws.

III. The Judgment

The House of Lords came to the unanimous conclusion that entering swap contracts was beyond the legal authority of the Council and all other local authorities subject to the Act. The swap transactions entered into since 1983 were all, according to the House of Lords, *ultra vires* of the powers of the Council and thus illegal.

IV. The Reasoning Behind the House of Lords' Decision

The House of Lords observed that pursuant to the Act a local authority has those powers, and only those powers, vested in it by the Act or otherwise. The Council could only do those things that were authorized by the Parliament of England. One of the Council's authorized powers was "borrowing," as defined and controlled by part I of schedule 13 of the Act. Another authorized power is contained in subsection 111(1) of the Act:

Without prejudice to any power exercisable apart from this section but subject to the provisions of this Act . . . a local authority shall have power to do anything (whether or not involving expenditure, *borrowing* or lending of money or the acquisition or

8. *Id.* at 549.

9. *Id.*

10. Local Government Act, 1972, ch. 70, § 111(1).

disposal of any property or rights) *which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions.* (Emphasis added.)

Rejecting the appellant's argument that the local authority's power to borrow was not a "function" within the meaning of subsection 111(1), the House of Lords held that borrowing was a power conferred upon the Council and was a "function," in the exercise of which the Council was permitted to do things that were "calculated to facilitate, or [were] conducive or incidental to" that function.¹¹ The issue in the case then became whether a swap transaction was "calculated to facilitate, or [was] conducive or incidental to" the discharge of the Council's authorized power and function of borrowing.

In the crux of the decision the Law Lords held that a power was not "incidental" under subsection 111(1) merely because it was convenient or desirable or profitable; consequently, swap transactions were not "incidental" to the Council's borrowing function.¹² The Law Lords rejected the view taken by the Court of Appeal that swap transactions were incidental to the more general function of "debt management":

Debt management is not a function. Debt management is 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 borrowing. The expression debt management could be employed to describe the duty of a local authority to consider from time to time whether it should change a variable P.W.L.B. loan into a fixed interest loan; whether it should redeem one loan and take out another; whether when a new borrowing is contemplated, the borrowing should be at a variable or fixed rate taking into account all the other borrowings of the local authority. Debt management is a phrase which describes prudent and lawful activities on the part of the local authority. If swap transactions were lawful a local authority would be under a duty to consider entering into swap transactions as part of its duty of debt management. But if a swap transaction is not lawful then it cannot be lawful for the local authority to carry out a swap transaction under the guise of debt management.¹³

Lord Ackner states further that "[a]lthough the phrase 'debt management' may be a convenient one, swap transactions in fact leave the debt wholly unmanaged."¹⁴

In a further attempt to save their deals, the banks argued that the swap transactions were akin to insurance contracts protecting the Council against possible risks. Lord Templeman responded first by making note of the huge variation in profit and loss that may be caused by a 1 percent increase or decrease of the LIBOR index in a swap contract based on a notional principal sum of £1 million, and then by stating that swaps were "more akin to gambling than insurance."¹⁵

Finally, the banks contended that if the swap transactions were ultra vires, the result would be so harsh that the swap market, the banks, and other parties to

11. 1991 All E.R. at 554.

12. *Id.*

13. *Id.* at 558.

14. *Id.* at 568.

15. *Id.* at 559.

swap transactions would suffer great difficulties; the creditworthiness of local authorities would be impaired, which would in turn result in increased taxation. The Law Lords shunned this plea by stating that even if the transactions were *ultra vires*, it need not be an automatic consequence that the Council could recover all the payments made by the Council to its counterparties, or that the banks could not recover the monies received by the Council.¹⁶ The consequence of any *ultra vires* transaction, the House of Lords held, would depend on the facts of the particular case.¹⁷

Briefly stated, the House of Lords held that the Council, while it was able to borrow, do other acts ordinarily given to a local authority, and do all things incidental in the exercise of its powers, was not authorized to enter swap contracts. No provision of the existing law could legitimize either directly or indirectly the Council's participation in swaps.

V. Analysis

A. WAS THE CASE CORRECTLY DECIDED?

On the particular facts and given the nature of the counterparties involved, it is difficult to argue that *Hammersmith and Fulham* was wrongly decided. The only aspect in which the House of Lords may have erred was in giving too restrictive an interpretation and application of the Council's power and function of borrowing.

Some may argue that swaps are, or should be considered, incidental or related to borrowing. Certainly, swaps often involve interest rates, although they may also take the form of currency or commodity swaps. The presence of interest rates, alone, however, does not suffice to characterize a swap as something incidental to borrowing. A swap transaction may be entered to parallel interest on particular borrowings, to reduce interest obligations, to hedge the party's risks, or to give a party access to an interest market that is otherwise not accessible. But because a party's swap or interest obligations are only based on a notional principal and not on an actual loan, the swap does not involve borrowing.¹⁸ Financiers, traders, economists, and other business people involved in the swap market will concede that a swap is an obligation to make a series of payments to a counterparty. (Such payments are calculated in reference to some indicator, for example, fixed or floating interest rates, and a notional principal.) There is no obligation on the counterparty to reimburse the payments made to it. There is no loan.

16. *Id.* at 560.

17. Unfortunately, the decision does not reveal what effect the finding of *ultra vires* had on the parties in this case. See Clifford Chance, *What Prospects of Restitution After Hammersmith and Fulham?*, INT'L FIN. L. REV., Mar. 1991, at 12.

18. Note that in some situations capital payments are made by and between the counterparties, but such payments are not part of the swap. They are usually part of a more extensive agreement between the parties.

This is the analysis stated by Lord Ackner:

The purpose and function of swap transactions is not to facilitate, to help, or to make more easy the discharge by the local authority of its function of borrowing. The original underlying debt or debts continue in existence and are all unaffected by the swap transactions. In many cases the swap transactions are entered into long after the underlying borrowing and probably were not even in contemplation when such borrowing took place. The function and purpose of the swap transactions is to alleviate the consequences of borrowing by the local authority purchasing what has been conveniently called "a stream of income" or "a cash flow" which will enable it to reduce the nett [sic] cost of its borrowing. In the words of Mr. Sumption Q.C., appearing for Barclays Bank, interest swap transactions are "a risk mitigating activity." They are designed not to meet any specific loss but to seek to ensure that the local authority pays as little interest on its loans as can be achieved. In this respect they are indistinguishable from any other transaction which involves the hope of gain, which gain is intended to reduce a risk attendant on an underlying transaction.¹⁹

To the extent that the Council could only do what was permitted by the Act (that is, only those acts "calculated to facilitate, or . . . conducive or incidental to" borrowing) the House of Lords had a difficult decision to make. In a strict legal sense, the House of Lords was correct in holding that swaps were not incidental to borrowing. Participants in the market will argue to the contrary—that in practical terms (the motivation for the swap deal and how the deal is structured) swaps are incidental to borrowing. However, for the purpose of defining the legal authority of a legislatively created entity, swaps could be construed to be not incidental to borrowing.

This distinction between the real world and the law is not useful and it explains the frustration with this decision felt by those who do not observe the legal dimension of the swap market. In a strict legal sense the decision is untouchable, but in a practical sense the decision seems, with all due respect, to be mistaken.

In reaching this narrow interpretation of swaps and borrowing, the House of Lords was probably affected by several factors, which are discussed below. In any future litigation an attempt should be made to distinguish the *Hammersmith and Fulham* case, or argue it was incorrectly decided, on two principal grounds: (1) the court did not observe the reality of the swap market; and (2) the court was affected by extrinsic factors. The first of these points was addressed above; consideration of the second follows.

B. WHAT WERE THE FACTORS THAT MAY HAVE INFLUENCED THE HOUSE OF LORDS IN RENDERING THIS DECISION?

1. *The Risk Involved*

The risk inherent in swap deals was a factor that affected the Law Lords' judgment. Lord Templeman stated that "[i]ndividual trading corporations and

19. 1991 All E.R. at 568.

others may speculate as much as they please or consider prudent. *But a local authority is not a trading or currency or commercial operator with no limit on the method or extent of its borrowing or with powers to speculate.*²⁰ Further on in his reasons, Lord Templeman stated that despite the arguments presented on behalf of the banks, there were “substantial risks” involved in swaps.²¹ As well, Lord Ackner took the time to reiterate the fact that swap transactions involve risk at two levels: a risk that the movements of interest rates will be contrary to what is anticipated; and the credit risk of the counterparty.²²

2. *Dealing with Taxpayers' Funds*

Undoubtedly, the House of Lords was also affected by the venturing of the local authority into a method of fund-raising (irrespective of whether the ulterior motive was reduction of the interest burden, or the hedging of risks) that was too risky given that it was being implemented by public funds. Lord Templeman stated that “[t]he local authority is a public authority dealing with public moneys, exercising powers limited by Schedule 13.”²³ “A local authority which borrowed in reliance on future successful swap operations would be failing in its duty to act prudently *in the interest of the ratepayers.*”²⁴

3. *Potential Huge Loss*

Hazell’s argument that if interest rates fell by 1 percent, the Council would lose £193.5 million also affected the Law Lords. Even more frightening was the prospect, as Hazell predicted, that if interest rates rose by 1 percent, the Council would lose £406.3 million.²⁵ The Law Lords did not want to sanction this huge loss, which in the end would be shouldered by the taxpayers. As far as the House of Lords was concerned, the unsuspecting taxpayers should not bear the risk of huge loss caused by the adventurous instinct of the members of the Council.

4. *Deference to Parliament*

Perhaps summarizing the underlying consideration of the Law Lords, Lord Ackner stated that:

Whether or not power should be given to local authorities to engage in interest swaps and if so the nature of those swaps, involves a balancing operation—balancing the advantages against the risks in the light of the overall need for such activity. *This is essentially a matter that should be left to Parliament, which, as with building societies, may wish to proceed, if at all, by stages.*²⁶

20. *Id.* at 556 (emphasis added).

21. *Id.* at 559.

22. *Id.* at 568.

23. *Id.* at 556.

24. *Id.* at 554 (emphasis added).

25. *Id.* at 552.

26. *Id.* at 568 (emphasis added).

The Law Lords observed that in other circumstances Parliament had specifically authorized swap transactions.²⁷ The taxpayers' money was at risk, and the House of Lords was not ready to shift the risk of the loss of such funds onto the taxpayers without legislative authority to do so.

The above four factors had an effect on the Law Lords and their judgment. The argument may be made that absent these four factors, a more generous interpretation of the Council's powers would have been given, and that in a case where these factors do not exist the counterparty should have the power to enter a swap.

C. WHAT ARE THE IMPLICATIONS OF THIS CASE?

The importance of this case lies not in any direct binding authority over transactions subject to Canadian or U.S. law, for it has no such effect. The fact that the local authority of *Hammersmith and Fulham* could not validly enter swaps is not what has concerned the "swap community."

Mistakenly, some of those who have read this important decision have concluded that swap transactions are in and of themselves illegal because they involve gambling. Although Lord Templeman made passing reference to this theory, it was definitely not the basis of his decision. The *Hammersmith and Fulham* case does not stand for the proposition that a swap contract is a gambling contract. (More likely than not, however, many litigators will use Lord Templeman's brief statement to argue that the swaps entered into by their defaulting clients are illegal.)

The case is important because of its significant impact upon the definition and characterization of swap transactions. The decision may be used to argue the following: That a counterparty having the ability to borrow and do other acts related to borrowing, but without specific ability given to enter swaps, is not empowered or authorized to enter a swap. This argument is a dangerous one because many parties in the swap market do not have specific authority to deal in swaps. The authority of a counterparty to borrow and do other acts related to borrowing is not sufficient.

This requirement of specific authority is peculiar to cases similar to this one in which the party can do only those things specifically authorized by law and in which the doctrine of *ultra vires* may be invoked. When the doctrine of *ultra vires* cannot be invoked, the party can enter swap contracts as it pleases (subject only to applicable laws such as banking laws, laws affecting interest rates, insurance and trust company laws, and other commercial laws). Whereas an entity such as a local municipality or government agency can only do those things specifically authorized, other entities can do all things so long as they adhere to the provisions of law. In evaluating a counterparty, therefore, it is necessary to decide which type of entity it is. If it is the type of entity that can only do that which is authorized, then specific authority for a swap is necessary.

27. *Id.* at 559.

The first question, therefore, is whether the counterparty can legally participate in the swap. The next logical question is, what happens when a party that is not legally authorized to enter a swap contract does so? Will a counterparty dealing in good faith be protected? Many persons considering the implications of the *Hammersmith and Fulham* case are not worried because they are confident that a good faith party will not be affected by the illegality, and that the obligations of the party illegally participating will remain executory. Is this confidence well founded? It depends on the party's legal status.

In reviewing a counterparty's legal position it is necessary to determine, regardless of whether an ultra vires act was committed, if pursuant to its constituting documents or the law, or both, that entity will remain bound and liable to a bona fide party dealing with it. For example, in Canada, if the counterparty is a corporation incorporated under the Canada Business Corporations Act (CBCA),²⁸ one may make the following arguments regarding the enforceability of a swap contract regardless of the fact that the swap transaction is ultra vires.

(1) CBCA subsection 16(3) provides that no act or transfer of property of a corporation is invalid by reason only that the act or transfer is contrary to the corporation's articles or the CBCA;

(2) CBCA subsection 18(a) provides that a corporation may not assert against the person dealing with the corporation or with any person who has acquired rights from the corporation that the articles, bylaws, or any unanimous shareholder agreement have not been complied with.

These provisions do not render the act that was contrary to the articles or the CBCA untouchable. All these provisions do is protect persons dealing with the company. The offending act remains tainted and for that reason it may be enjoined by shareholders or be the subject of litigation between the corporation and its personnel or other interested third parties. Therefore, even where there is a provision that protects a good faith counterparty, it is important to review the counterparty's authority to enter the swap. Otherwise, although neither party to the swap could invoke the doctrine of ultra vires, the transaction or the counterparty, or both, may be adversely affected by a shareholder or another interested party.

Note that for companies incorporated under the CBCA, subsection 15(1) provides that a corporation has the capacity, rights, powers, and privileges of a natural person. The banks in the *Hammersmith and Fulham* case attempted to make this argument, but the House of Lords rejected it because there was no statutory or other authority supporting the proposition that the Council constituted a natural person. Presumably a natural person is always entitled to enter a swap. Subsection 15(1) of the CBCA does not go to the second level of analysis (that is, enforceability), but rather to the first consideration of whether the entity had the authority to enter the swap in the first place. Subsection 15(1) means that

28. R.S.C. ch. C-44 (1985).

the doctrine of ultra vires no longer applies to CBCA companies and that from a legal and corporate point of view a CBCA corporation may participate in swaps without further specific authority being required.

In summary, the two questions that must be determined prior to agreeing to enter a swap are: (1) whether the counterparty is legally entitled to specifically participate in swaps; and (2) even if the proposed counterparty is not specifically authorized to participate in a swap, will a bona fide transaction to which the counterparty has committed itself be enforceable?

Under most modern company laws, provisions similar to those found in the CBCA will afford the assurance sought by the latter question.²⁹ Particular attention should be given to, among others, counterparties constituted by private laws, crown corporations, insurance companies, trust companies, local governments, government agencies, nonprofit organizations, and heavily regulated monopolies, industries, and businesses.

VI. Conclusion

This recent decision by the House of Lords has thrown a degree of doubt over the enforceability of swap contracts. As one might anticipate, banks are now somewhat confused and nervous as to how to deal with certain counterparties. Interestingly, the Law Lords never stated what they thought would be the consequence of this ultra vires transaction. Are the parties put back, assuming this is possible, in the financial positions in which they were before the contract was entered? Do all parties involved in the illegal swap refund all payments received? Does the illegality of the swap contract only affect future payments? What of a situation in which the taxpayers are in a winning swap transaction? These are all questions that remain unresolved subsequent to the *Hammersmith and Fulham* decision.

Before the House of Lords rendered its decision it was generally thought that once and for all the legality of swaps would be settled in the affirmative. Not only were swap dealers looking forward to knowing that the Council had the legal authority to enter the swap contracts, but also that swaps would not be characterized as gaming contracts. The hope was that the decision would address other questionable traits of swap contracts and dismiss them so that the swap market could develop subject only to the dictates of the market. In the end none of these hopes were fulfilled.

The facts of the *Hammersmith and Fulham* decision were quite particular and, at least to a certain extent, the Law Lords were probably affected by the factors discussed above. These factors and the divorce from reality that the court exer-

29. See also Delaware General Corporation Law § 124, DEL. CODE ANN. tit. 8, § 124 (1990), and Company's Act 1989, § 35(A) (U.K.).

cised could be used to distinguish the case or even to argue that it was incorrectly decided.

What progress has been made? The decision does not mean that swaps are entirely legal. Nor does it mean that swap contracts are illegal. What the decision tells swap dealers is that they must do their due diligence research in a more thorough fashion and not to assume that the swap is always within the authority of their counterparty. Many more cases will have to be decided before the questions discussed in this commentary and the issues raised by the *Hammersmith and Fulham* judgment will be resolved.

Before the House of Lords rendered its decision many were of the view that the House of Lords would never come down against the swaps. Similarly, today traders in other financial centers around the world are stating that if similar questions were to be raised in their jurisdictions, the swap would surely be held by their more open-minded, commercially astute, and progressive courts to be legal in all respects and binding. Was this attitude justified before the *Hammersmith and Fulham* decision? Apparently not. Is this attitude justified in the light of the *Hammersmith and Fulham* decision?

