AVOIDING THE INEVITABLE? CHANGE OF POSITION AND RESTITUTION OF SUMS PAID UNDER VOID CONTRACTS

In this column, Richard Hanke of 3 Verulam Buildings looks at the situation where parties to a finance contract find themselves having to repay sums of money because contracts later turn out to be void, and what defences are available.

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Two parties entered into a financial agreement many years ago, made substantial payments to one another and had entered into onward transactions relying on the validity of the agreement. If the agreement is subsequently held to be void, what are the consequences? The law of unjust enrichment and the defence of change of position may provide answers. Until recently, however, a number of unresolved questions remained in this area. A series of cases concerning swaps entered into by Italian authorities is now providing some welcome clarity in this field. The most recent is the decision of Foxton J in *Banca Intesa Sanpaolo SPA & Anor v Comune Di Venezia [2022] EWHC 2586 (Comm)*, which also suggests safeguards against some of the issues that have arisen in this series of cases.

THE CHANGE OF POSITION DEFENCE

The change of position defence enables a party facing an unjust enrichment claim to reduce the sum they are otherwise obliged to return if they had, in good faith, spent the money that they had received. It was first recognised by Lord Goff in *Lipkin Gorman v Karpnale Ltd [1991] 2 AC 548* at 580, when it was set down in wide terms: *'the defence is available to a person whose position has so changed that it would be inequitable in all the circumstances to require him to make restitution, or alternatively, to make restitution in full.'*

The broad and fact sensitive nature of the defence has been emphasised in later cases, particularly *Niru Battery Manufacturing Co v Milestone Trading Ltd [2004] QB 985*, which stipulated that the *'essential question is whether it would be inequitable or unconscionable, and thus unjust, to allow the recipient of money paid under a mistake of fact to deny restitution to the payer.'*

THREE ISSUES CLARIFIED IN THE RECENT CASE ON CHANGE OF POSITION

Venezia considered whether interest rate swaps entered into between the claimant banks and defendant Italian authority in 2002 were valid and binding. Foxton J held that the question of capacity fell to be determined in

accordance with Italian law. Following a decision of the Italian Supreme Court in 2020, the city of Venice had lacked capacity with the result that the swaps were void. The judgment then addressed the unravelling of those transactions: Venice claimed restitution of the sums that it had paid. The banks relied upon the defence of change of position that they said arose from transactions they had been entered into to hedge their exposure under the swaps, and payments that they had made under those hedging transactions.

In considering these matters, the court addressed three important issues:

- The proper law for restitution claims arising out of a void contract.
- Whether the defence of change of position can ever be available when unravelling payments under a void contract.
- How to apply the defence of change of position to payments made pursuant to agreements that had been entered into in anticipation of receipts under a void contract.

Foxton J presciently observed that his decision on these points would likely be subject to more attention than it had received in the course of argument at trial.

IS ENGLISH LAW STILL APPLICABLE?

Before considering the defence of change of position, the court first had to determine the applicable law for the unjust enrichment claim. The applicable law was determined under the common law principles of conflict of laws, applying the law with the *'closest and most real connection'.* Foxton J prioritised the law chosen by the parties in the choice of law clause applicable to the swaps, even though he had held them to be void.

This departed from the decision in *Dexia v Comune di Prato [2016] EWHC 2824 (Comm),* which had prioritised the connections with Italy in a similar case but followed the approach of Cockerill J in *Deutsche Bank AG London v Comune di Busto Arsizio [2021] EWHC 2706 (Comm)*. Foxton J considered it 'highly significant' that the payments were made and received on the basis of assumed English law obligations, meaning that the *'natural expectation'* of the parties was that English law would apply to rights of recovery.

It is difficult to see this other than as a convenient fiction – it cannot be assumed that an Italian authority, found, as a matter of Italian law to have exceeded its capacity, would have assumed English law would apply to the recovery of sums that it paid. Focus upon the choice of law clause does, however, provide certainty. The judgment also identifies a further solution: a choice of law clause drafted to take effect as an *'ancillary agreement that English law would apply to claims arising from the purported entry into the contract even if it was void for lack of capacity.'*

IS THE CHANGE OF POSITION DEFENCE AVAILABLE WHEN UNRAVELLING PAYMENTS UNDER VOID CONTRACTS?

Venice contended that the validity of the contract – and the existence of a legally enforceable right to counter-performance – was one such condition.

This argument relied upon *Haugesund Kommune v Depfa ACS Bank [2012] QB, 549*, where the defendant authorities were barred from relying on the defence in response to claims by a bank that had paid them money under void 'swap' agreements. Importantly, however, the sums paid by the banks under the transactions in that case would always have been repaid – they were not straightforward swaps.

Foxton J focused upon this difference, and, by application of first principles, concluded that there was no automatic bar to the defence in this case. He stated that to exclude the defence would amount to its exclusion in every void contract case, which could not be correct and would ignore the important justifications for the defence.

In this respect the decision is part of a welcome move to focus upon the broad formulation of the defence and the *'essential question'*: would it be *'inequitable or unconscionable for unjust enrichment to be denied'* as a result of the knowledge of the recipient? In cases in which restitution has been refused on this ground the recipient was always aware that the payments were conditional.

There is no defence because the law considers that the recipient cannot have spent the money in the honest belief that the transferor had an unqualified intention to benefit them. By contrast in Venezia, although the parties assumed they owed one another binding obligations, neither party considered the payments to be conditional: Venice's claim was founded on its mistake and not an absence of basis.

HOW TO APPLY THE CHANGE OF POSITION DEFENCE TO PAYMENTS MADE IN ANTICIPATION OF ENTERING INTO THE NOW VOID CONTRACTS

Venice had also argued that the Bank could not use the change of position defence because the hedging transactions relied upon had been entered into before the receipt of any payments from Venice. Reliance was placed on two earlier first instance decisions (*Westdeutsche Landesbank Girozentrale v Islington LBC [1994] 4 All ER 890* and *South Tyneside MBC v Svenska International plc [1995] 1 All ER 545*) refusing to permit the defence to be relied upon in relation to similar onward hedging transactions. Those cases have, however, been subject to recent criticism by academics and Judges. Cockerill J had, for example, indicated in Busto that she would not have followed these decisions.

Following a detailed analysis, Foxton J also declined to follow these decisions and held that change of position was in theory available to temper *'at least some of the consequences which would otherwise flow from a legal development in 2020 leading to a transaction which both parties had treated as binding for nearly 13 years being held to be void from the outset'*:

- He noted that the analysis in these two decisions had been surpassed by developments in the law of unjust enrichment, which now recognises that a change of position defence can be available where a payment was made in anticipation of the receipt of funds (*Dextra Bank and Trust Co Ltd v Bank of Jamaica [2002] 1 All ER 193* and *Jones v Commerzbank AG [2003] EWCA Civ 1663*)
- He ruled out any particular public policy objection that might prevent the defence being available to a bank facing a claim from a public authority.
- He held that although issues of causation and quantification might be difficult, that should not prevent the defence being available.

In relation to the causation issue, Foxton J concluded that, applying a common-sense test, the bank had incurred the expenditure in reliance upon anticipated payments from Venice, and that such back-to-back transactions were routine and objectively foreseeable. He dismissed the broader purpose of the swaps – the banks having entered into the onward transactions to hedge the risk arising from the Venice swaps generally – focusing instead upon the reality of the position of the bank. There is a welcome realism to this decision and its recognition of the position of the banks as a *'paradigm case for the availability of the defence of change of position'*.

As for quantification, Foxton J disregarded the possibility that the hedging transactions may in future lead to the Banks receiving payments, which he characterised as *'an argument that the recipient is unable to establish that they are worse off because the final outcome of the hedging transaction is not yet known'.* This was because the quantum of the change of position had to be determined as at the date of the demand for repayment. The chance of future payments was therefore irrelevant. By analogy with a contractual damages claim, if the Banks chose to retain their onward hedges after that date, that was at their own risk.

What the judgment did not address, and which would complicate the analysis of quantification, is if the bank had terminated the onward hedges (or argued that it would have terminated them) and made an early termination payment. It could be argued that such payment would also have to be taken into account. Just as a recipient that changes their position by acquiring a valuable asset must give credit for the surviving value, a crystallised surviving liability should also be taken into account. A failure to do so would leave the recipient out of pocket.

DRAFTING SOLUTIONS

As is often the case with decisions addressing complex financial agreements, Venezia offers some pointers as to how drafting may avoid or minimise the issues that arose in this case. In particular, Foxton J drew heavily upon the presumed intentions of the parties as had been indicated by the terms of the swaps, even though they were held to be void. Thus, there is potential for parties to seek to provide some certainty as to the scope and parameters of unjust enrichment claims if the contract is held to be void by making their shared intentions express within those agreements. For example:

- Parties should consider whether they wish a choice of law to apply to disputes arising in relation to the recovery of payments made under the agreement if the agreement is held to be (or alleged to be) void. Even if such a fully severable clause is not used, parties should consider the precedence that the court is likely to give to the law identified in that clause.
- Parties should consider whether they wish to expressly record their intentions as to the allocation of risk in the event that a transaction is held to be void, and whether also to attempt to record those intentions in a

separate or severable agreement that may survive a conclusion that a particular transaction was void. A Master Agreement may sometimes fulfil this role (but see *Venezia* para [361]).

- Parties may wish to confirm whether payments are transferred for limited purposes, including whether, for example, parties receiving payments under the agreement are subject as to any restrictions or expectations as to what use they may make of that money, or whether they are free to deal with it as they see fit.
- If it is intended that a party will enter into transactions with third parties in reliance upon the existence of the principal agreement, there may be a benefit in referring to that intention.

The judgment did, however, highlight some limitations to the power of inventive drafting, rejecting the Bank's arguments in relation to contractual estoppel (in relation to which see, 3VB's finance column: *Don't estop me now! Contractual estoppel and capacity to enter into finance contracts*), breach of contract, and a misrepresentation claim based upon terms of the Master Agreement.