Lender Liability in Negligence: The Swiss Franc Saga

Shane Tulloch

Joint Winner of the Law Review Prize for 1992

I: INTRODUCTION

The application of negligence law to foreign currency loans has arisen through a line of recent Australian decisions known as the "Swiss Franc" cases. Australian borrowers were attracted to foreign currency loans by substantially lower offshore interest rates compared with those available in the domestic market, and an initial period of stability in exchange rates following the float of the Australian dollar in 1983. However, since the obligation to repay was fixed in the foreign currency, any fall in the value of the domestic currency[1] resulted in an increase in the amount of domestic currency required to repay the principal and interest. Faced with ballooning debts, Australian borrowers argued that they were not properly warned of this risk, and that the nature of a foreign currency loan was misrepresented to them. Furthermore, the difficulty in managing such a loan during periods of exchange rate volatility was not explained, nor was any assistance given.

A recent New Zealand case, *Citibank NA v Stafford Mall Ltd*[2] appears to have set the stage for a series of similar claims in New Zealand.[3] The volatility experienced by the New Zealand dollar since it was floated in 1985, along with (until recently) high domestic interest rates, appears to provide the requisite factual background for litigation by foreign currency borrowers.

---

1 The Australian dollar fell in 1985 to less than half its previous value.

2 Court of Appeal, 10 June 1992, CA 235/91 (Cooke P, Richardson and Hardie Boys JJ).

3 See "Citibank Case May Open Floodgates", *National Business Review*, 13 May 1991, 1.

The scope of this article will be confined to the liability of lenders in respect of foreign currency loans. The Swiss Franc cases demonstrate the manner in which the Australian courts have approached the existence and nature of a duty of care in novel circumstances of pure economic loss. The duty issue involves negligent misstatement, negligent omission (failure to explain, warn, or advise) and difficulties in establishing the appropriate standard of care in the context of the foreign exchange market. The central purpose of this article is to suggest the formulation of the duty of care which New Zealand courts should adopt. It is submitted that the Australian approach proceeds on a misconceived understanding of foreign currency loans and the foreign exchange market.

II: ASSESSING THE DUTY OF CARE IN NOVEL SITUATIONS

There is no New Zealand authority applying negligence law to the relationship between the parties to a foreign currency loan. The acceptance by the Australian courts of the existence of a duty of care in a number of Swiss Franc cases provides persuasive authority for the recognition of a duty in New Zealand. However, given the apparent widening divergence between the attitude of the English and Australian appellate courts and the New Zealand Court of Appeal, such recognition will not necessarily follow. It is therefore necessary to identify the test currently applied by the New Zealand courts for assessing the duty of care in novel situations.

The latest statement from the Court of Appeal in *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd*[4] contains an extensive discussion of the New Zealand approach to the duty issue, as compared to that adopted in England and Australia.[5] All five members reaffirm the test applied in *Brown v Heathcote County Council*[6] and *Downsview Nominees Ltd v First City Corporation Ltd*,[7] which is succinctly restated by Richardson J:[8]

> The ultimate question is whether in the light of all the circumstances of the case it is just and reasonable that a duty of care of broad scope is incumbent on the defendant .... It is an intensely pragmatic question requiring most careful analysis ... and, drawing on *Anns v Merton London Borough Council*, we have found it helpful to focus on two broad fields of enquiry. The first is the degree of proximity or relationship between the alleged wrongdoer and the person who has suffered damage. That is not of course a simple question of foreseeability as between parties. It involves consideration of the degree of analogy with cases in which duties are already established and ... reflects an assessment of the competing moral claims. The second is whether there are other policy considerations which tend to negative or restrict – or strengthen the existence of – a duty in that class of case.

---

4 [1992] 2 NZLR 282; see also *Deloitte Haskins & Sells v National Mutual Life Nominees Ltd* (1991) 5 NZCLC 67,418, 67,425 (CA) per Casey J; 67,440 per Gault J.

5 See also Case Note, infra at p212.

6 [1986] 1 NZLR 76, 79 (CA).

7 [1990] 3 NZLR 265, 275 (CA).

8 Supra at note 4, at 306.

The Court firmly rejects a submission that New Zealand should abandon its approach[9] in the light of *Murphy v Brentwood District Council*[10] and "adopt an avowedly incremental approach"[11] to novel situations. Cooke P notes that, while reasoning by analogy should be and has been used as part of the New Zealand approach, labels such as "incremental" solve few problems.[12] The courts have been consumed with defining the formula or test, when the real objective is to carefully weigh all the competing considerations in order to decide whether liability should be imposed.[13] Thus, the judgments indicate that any difference between the New Zealand approach and that adopted in England and Australia appears to be one of form and not substance.

There is a further aspect of the decision which is important in relation to the duty issue in the Swiss Franc cases. Cooke P stresses that the fact that economic loss, rather than physical injury, has been suffered may weigh against a duty of care, but it is certainly not decisive.[14] Such categorisation of different types of loss is not considered helpful. His Honour affirms that there are many New Zealand examples where a duty to prevent pecuniary loss has been found.[15]

There are two broad categories of negligence which may arise in the context of the Swiss Franc cases. The first is negligent misstatement, being a duty to take care where advice or information is given in response to a request or, alternatively, where it is voluntarily provided. This is a recognised and accepted category of liability for pure economic loss.[16] Attention will be focused on the second category which is negligent omission, being a duty to explain, warn or give advice.

Negligent Omission

Negligent omission gives rise to problems in the recognition of a duty. In situations of pure nonfeasance, where the plaintiff is put at risk from a source quite unconnected with the defendant, there is no duty sounding in tort requiring the defendant to intervene.[17] Lord Atkin's famous statement of principle in *Donoghue v Stevenson*[18] included both acts and omissions which might foreseeably injure one's neighbour. However, the statement contemplated only those omissions arising in the course of some wider activity involving positive conduct.[19]

---

9 Ibid, 306 per Richardson J; 312 per Casey J; 316 per Hardie Boys J; 325 per Sir Gordon Bisson.

10 [1991] 1 AC 398 (HL).

11 Supra at note 4, at 306.

12 Ibid, 295.

13 Ibid, 294 per Cooke P; 313-314 per Casey J; 316-317 per Hardie Boys J.

14 Ibid, 296.

15 For example, *Mainguard Packaging Ltd v Hilton Haulage Ltd* [1990] 1 NZLR 360 (HC); *Williams v Attorney-General* [1990] 1 NZLR 646 (CA).

16 *Hedley Byrne & Co Ltd v Heller & Partners* [1964] AC 465. Endorsed by all their Lordships in *Murphy v Brentwood DC*, supra at note 10, at 468, 479, 485, 492-493.

17 *Home Office v Dorset Yacht Co Ltd* [1970] AC 1004, 1060 (HL) per Lord Diplock.

18 [1932] AC 562.

19 Todd (ed), *Law of Torts in New Zealand* (1991) 131.

The famous definition of negligence given by Alderson B in *Blyth v Birmingham Waterworks Co* certainly contemplates negligence by omission:[20]

> Negligence is the omission to do something which a reasonable man, guided upon those considerations which ordinarily regulate the conduct of human affairs, would do, or doing something which a prudent and reasonable man would not do. The defendants might have been liable for negligence, if, unintentionally, they omitted to do that which a reasonable person would have done ...

However, this presupposes the existence of a duty to act in the first place:[21]

> There can be no liability for a failure to tender advice unless there exists a legal duty to advise, nor for the quality of that advice unless there is a duty to exercise some measure of skill and professional competence in formulating it.

Thus, the general principle is that "a person is bound not to inflict damage on another but is not bound to take positive action to prevent injury to, or otherwise confer a benefit on, that other".[22] The reason for the law's reluctance to recognise liability for omissions stems from problems of causation and policy considerations. The imposition of a duty may be an unjustifiable abridgement of individual freedom, requiring the defendant to engage in risky, time-consuming, costly and burdensome activity for no personal benefit. Such obligations of affirmative action have traditionally been assumed under contract, but it has been considered inappropriate to impose them in tort. A practical problem of identification of the correct defendant may arise in the case of a large number of potential assisters who have failed to act. The courts are wary of the possibility of an indeterminate expansion of positive duties to act.[23]

First exception

The force of these objections largely evaporates where the plaintiff *reasonably relied*[24] on the defendant acting for his or her benefit or where the defendant *exercised control*[25] over or *assumed responsibility*[26] for the circumstances giving rise to the danger. Thus, the first exception is that a duty to act will be more readily recognised in the presence of the elements of reliance, control and the assumption of responsibility. For example, in *Hawkins v Clayton*[27] Deane J indicated that in

---

20 (1856) 11 Exch 781, 784; 156 ER 1047, 1049.

21 Allan, "Bankers' Liability For Financial Advice" (1987) 16 MULR 213.

22 Supra at note 19, at 132.

23 See *Hill v Chief Constable of West Yorkshire* [1989] AC 53 (HL), where the parents of a murder victim alleged that police were under a duty to protect citizens from an identified serial killer.

24 *Brown v Heathcote County Council* [1987] 1 NZLR 720 (PC) (reliance on the previous practice of a drainage board who omitted to warn that land on which a house was to be built was susceptible to flooding).

25 The powers of control exercised by virtue of a public office may lead to a duty to prevent injury: supra at note 17.

26 In the building cases a duty can be founded on the assumption of responsibility to safeguard the home-owner or control the work of the builder: supra at note 24.

27 (1988) 164 CLR 539 (HCA).

the presence of these elements, there may be a relationship which is sufficiently proximate to give rise to a duty to take positive steps to prevent physical damage or economic loss being sustained by another person. Gaudron J also considered the situation where the parties were sufficiently proximate to give rise to a duty of care in relation to the provision of information. She considered that there was no reason in principle why disclosure of information could not be required to comply with that duty. Her Honour saw no reason to distinguish between breaches of such a duty, whether resulting from an act or an omission.

A similar comment was made by Gault J in *Deloitte Haskins & Sells v National Mutual Life Nominees Ltd* in the context of negligent misstatements:[28]

> [T]he duty extends not only to the making of the statement but also to the carrying out of any enquiry necessary to enable the statement to be made. In that relationship there is no material distinction between negligent statements and negligent failure to make a statement where there is a duty to make it.

However, a problem in establishing reliance as a basis of liability for omissions was identified in *San Sebastian Pty Ltd v The Minister Administering the Environmental Planning and Assessment Act 1979*.[29] The High Court of Australia commented that reliance may not be present where the economic loss results from an act or omission outside the realm of negligent misstatement. There will be situations where it is difficult to reason that a plaintiff has relied on information or advice which the defendant failed to provide. The plaintiff will not even have been aware of the undisclosed material, much less have relied on it. In the *South Pacific Manufacturing* case Cooke P noted that many pecuniary loss situations may not easily be pressed into the *Hedley Byrne* type of reliance.[30] In such circumstances, indirect reliance on the carefulness of a general practice might be enough. His Honour concluded that foreseeable reliance on the carefulness of the defendant is only one factor to be considered in testing proximity.

The solution proposed by Gaudron J in *Hawkins v Clayton* is that the relevant factor of proximity can be identified in terms of reasonable expectation, a concept more readily applicable to omissions than reliance:[31]

> Thus a relationship of proximity may be constituted by the reasonable expectation of a person (including a reasonable expectation that would arise if he turned his mind to the subject) that the other person will provide relevant information or give reliable information, if that expectation is known or ought reasonably to be known by the person against whom the duty is asserted. Of course, the foreseeability of the risk of injury is necessarily relevant to a consideration of the reasonableness of expectation.

In situations where certain information is essential to the exercise or enjoyment of a legal right by another, the provider of such information is in a position of control

---

28 Supra at note 4, at 67,440.

29 (1986) 162 CLR 340, 355 (HCA) in the joint judgment of Gibbs CJ, Mason, Wilson, and Dawson JJ.

30 Supra at note 4, at 297.

31 Supra at note 27, at 596.

and ought to have the other person in contemplation as being affected by failure to disclose.[32] A material factor placing the provider of information in a position of control is the exclusivity of possession of that information.[33] However, as Gaudron J comments, exclusivity may not be an essential factor:[34]

> It may be, for example, that the person against whom the duty is asserted knows or ought to know that the significance of information of which he is possessed will not be apparent to others possessed of the information.

In the context of the Swiss Franc cases, the knowledge of the lender compared to that of the borrower will be of importance, as will be the superior access of the lender to expertise. A further point, not always fully appreciated in the Swiss Franc cases,[35] is that the elements of reasonable reliance and assumption of responsibility are alternatives, and not cumulative criteria for the relationship of proximity. Furthermore, they are not the sole or necessary determinants.[36] If the lender has in some way undertaken a responsibility to act, reliance is not required[37] (although it may constitute an alternative basis establishing the existence of a duty).

Second exception

The second exception arises from the fact that the characterisation of conduct as an omission to act, or nonfeasance (as opposed to misfeasance), may depend on the level of abstraction applied.[38] The line between passive inaction and active misconduct is a fine one. In *Hawkins v Clayton* Gaudron J said:[39]

> It may be that in a particular context failure to disclose some matter where other information is being imparted brings about a situation, foreseeable by the information giver, which amounts to the recipient treating that non-disclosure as a statement of some relevant fact.

For example, silence may constitute misrepresentation where a speaker omits to mention a qualification, thus rendering an absolute statement misleading. Similarly, the omission to disclose a subsequent change in circumstances which alters the validity of a previous statement may be considered a positive misrepresentation when viewed in a broader context.[40] Thus, a duty to disclose or explain may arise where, upon consideration of the wider circumstances, mere non-disclosure would be a misstatement within the bounds of *Hedley Byrne* liability. This was

---

32 Ibid.

33 *Shaddock & Associates Pty Ltd v Paramatta City Council* (1981) 150 CLR 225, 243 (HCA).

34 Supra at note 27, at 597-598.

35 For example, *Kullack v ANZ Banking Group Ltd* (1988) ATPR 49,310; *McEvoy v ANZ Banking Group Ltd* (1990) Aust Torts Reports 67,690 (NSW CA).

36 Supra at note 27, at 578-579. For example, see *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd*, supra at note 4.

37 *Horsley v McLaren* (1971) 22 DLR (3d) 545 (SCC) (boat-owner under duty to rescue guest who had fallen overboard).

38 Fleming, *The Law of Torts* (7th ed 1987) 134.

39 Supra at note 27, at 593.

40 *Rhone-Poulenc Agrochimie SA v UIM Chemical Services Pty Ltd* (1986) ATPR 53,043.

accepted in principle by the English Court of Appeal in *Banque Keyser Ullmann SA v Skandia (UK) Insurance Co Ltd.*[41]

In the context of the Swiss Franc cases, it is almost inevitable that there will have been some discussion between the bank and the customer as to the features of a foreign currency loan. Hence it is frequently alleged that the explanation given was inadequate and therefore positively misleading.[42]

Third exception

The third exception is that the creation of a situation of peril or risk, even without negligence, generates a duty to warn or adopt precautions to protect others from impending harm. The defendant will only escape liability in situations of "purest nonfeasance"[43] where the source of the danger is entirely unconnected with the defendant, although he or she may have "set the scene".[44] This raises the question of whether a bank creating and marketing foreign currency loans, with knowledge of the risks and in a controlling position, may no longer be regarded as a stranger without any responsibility to warn or offer advice or an explanation.

Summary

The question of whether it is just and reasonable to impose a duty requires an assessment of both proximity and policy.[45] Whether there is a sufficiently proximate relationship will depend on a combination of factors including:[46]

> ... the foreseeability of harm; the kind of harm, whether physical or purely economic; the immediacy of the risk of that harm; the degree and magnitude of that risk; whether there has been an assumption of responsibility by the defendant towards the plaintiff; the degree of reliance that one party places on the other, and the extent to which the latter is aware of it; the availability of other remedies; the extent of the burden the imposition of a duty would place on the defendant. Analogy with other cases may be helpful and important. Then in the policy area, such questions arise as the "floodgates" potential, the integrity of other legal principles, general economic considerations, and the need to preserve a fair and proper balance between the differing interests of persons going about their business or their daily lives.

---

41 [1990] 1 QB 665 (CA); [1991] 2 AC 249 (HL). In New Zealand the issue was raised in the context of a bank's duty to disclose to a guarantor: *Shotter v Westpac Banking Corporation* [1988] 2 NZLR 316 (HC); *Westpac Banking Corporation v McCreanor* [1990] 1 NZLR 580 (HC); *Shivas v Bank of New Zealand* [1990] 2 NZLR 327 (HC).

42 For example, see *Commonwealth Bank of Australia v Mehta* (1991) 23 NSWLR 84 (CA); *Quade v Commonwealth Bank of Australia* (1991) ATPR 52,476; *David Securities Pty Ltd v Commonwealth Bank of Australia* (1990) 93 ALR 271.

43 Supra at note 38, at 135.

44 *Smith v Littlewoods Organisation Ltd* [1987] AC 241 (HL).

45 *South Pacific Manufacturing Co Ltd v New Zealand Security Consultants & Investigations Ltd,* supra at note 4, at 317 per Hardie Boys J.

46 Ibid.

III: INTEREST RATE PARITY, ARBITRAGE AND MARKET EFFICIENCY - "THERE'S NO SUCH THING AS A FREE LUNCH"

General Principles of International Finance

> In the absence of market imperfections, risk-adjusted expected real returns on financial assets will be the same in foreign markets as in domestic markets. Equilibrium among the current exchange rate, the forward exchange rate, the domestic interest rate, and the foreign interest rate is achieved through covered interest arbitrage.[47]

Looking at the first sentence, it is a general principle that in the case of investment opportunities of identical risk, capital which can flow freely from country to country should seek the highest return available. However, investing, or conversely borrowing, in a foreign currency involves the risk of movements in the spot exchange rate[48] during the term of the loan. As a result of exchange rate fluctuations, a borrower may be required to pay a greater or lesser amount of principal than that originally borrowed in order to meet repayment obligations. Similarly, the amount of domestic currency required to meet interest obligations may fluctuate. This risk may be reduced or eliminated by entering into a forward contract at the start of the loan, thereby fixing the exchange rate to be applied at the time of repayment. The agreed exchange rate is called the forward rate.

The interest rate parity theorem argues that when financial markets are in equilibrium, the forward exchange rate will differ from the spot rate by an amount which reflects the difference in domestic interest rates between one country and another.[49] In other words, the forward exchange rate will be at a premium or a discount to the spot rate, depending on whether domestic interest rates are higher or lower than those of the foreign currency.

The second sentence argues that the existence of profit-seeking arbitrageurs will ensure that financial markets are in equilibrium, so that this equality between interest rate differentials and forward premia/discounts will always hold.

If financial markets are in disequilibrium, then the arbitrageur operates simultaneously in spot and forward foreign exchange markets, as well as foreign and domestic money markets. For example, suppose that the interest rate differential is greater than the difference between the forward and spot rates. An arbitrageur could borrow funds at the low interest rate, exchange the funds at the spot rate for the currency offering the higher rate of interest, and lend at this higher interest rate. At the same time, the arbitrageur would enter into a forward contract for the repatriation of the funds at the forward rate upon maturity. The cost of hedging in

---

47 Copeland & Weston, *Financial Theory and Corporate Policy* (3rd ed 1988) 796.

48 The exchange rate for immediate delivery of the currencies to be exchanged.

49 Supra at note 47, at 795-796; see also Karacaoglu (ed), *An Introduction to Financial Markets in New Zealand* (1988) 120.

the forward market would be the difference between the forward and the spot rates. The forward contract would sell at a premium, causing an exchange rate loss. *Ex hypothesi,* this loss would be smaller than the gain made from the interest rate differential. A riskless profit would arise without the outlay of any capital.

However, the aggregate actions of all arbitrageurs ensures that prices are brought back into alignment. Borrowing in the first money market increases the demand for funds and so pushes up the low interest rate in that market. At the same time, lending in the second market increases the supply of funds and so pushes the interest rate down in that market. The interest rate differential narrows. In the foreign exchange market the spot rate for the low interest rate currency falls under selling pressure, whereas the forward rate for that currency is buoyed by demand. Hence the forward margin widens until it equates with the narrowing interest rate differential. There is no pressure for further change since there is no longer a profitable arbitrage opportunity. The interest rate parity relationship is re-established.

A further insight relating to interest rate parity can be gained from the general principle of international finance outlined above. It was stated that, subject to adjustments for differences in risk, expected returns will be the same in foreign markets and domestic markets. On this basis, if expected return is to be equal in circumstances where interest rates differ between countries, the spot exchange rate would be *expected* to adjust to exactly offset the interest rate differential between the two currencies. The high interest rate currency would be *expected* to depreciate relative to the low interest rate currency (which would, relatively speaking, be appreciating) by an amount which reflects the difference between the interest rates in the two countries. Once the expected movement in the spot exchange rate is taken into account, the anticipated return on financial assets would then be equal.

The theory is based on the principle that capital markets utilise information efficiently:[50]

> In an efficient capital market, prices fully and instantaneously reflect all available relevant information.

In the context of the foreign exchange market, all publicly known[51] information concerning the future value of a currency will be impounded into the current spot exchange rate, for example: historical spot rate movements; economic fundamentals such as government deficits, trade flows and balance of payment figures; forecasts by economists; and political events such as policy statements by government ministers or the invasion of Kuwait. New information relevant to the value of

---

[50] Ibid, 331; see also Elton & Gruber, *Modern Portfolio Theory and Investment Analysis* (3rd ed 1987) 361.

[51] This would not preclude insiders, with access to price-sensitive information before it is made available publicly, from systematically predicting some price movements and earning abnormal returns.

a currency will result in an instantaneous and unbiased[52] adjustment to the exchange rate, just as it will in relation to interest rates in the money market. Currently held expectations and perceptions of future movements will also be reflected in current prices.

If current spot rates fully reflect all publicly available information, they must be priced so that expected future movements will offset the differences in interest rates. If not, then it would be possible to invest (or conversely, borrow) in a country where the interest rates were high (low) and the exchange rate was not expected to adjust to the extent of the interest rate differential. Expected returns, adjusted for differences in risk, would be unequal. Capital would flow into the currency with the highest expected return for the same risk, thus altering the relative value of that currency. This action would cause the exchange rate to adjust until the dynamic equilibrium was re-established and expected returns were equal.

This idea is closely related to interest rate parity, whereby the interest rate differential is reflected in the forward exchange rate premium or discount. The *expected* change in the spot exchange rate therefore equates with the forward rate premium/discount. Given the interest rate parity equilibrium driven by arbitrage activity, forward exchange rates should be unbiased predictors of spot rates *expected* in the future.[53] It is important to realise, however, that forward rates are only unbiased forecasts of *expected* changes in the spot rate. Actual outcomes are totally uncertain:[54]

> In one perspective, if the foreign exchange markets are efficient and the interest rate parity relationship always holds, then the future expected exchange rates will be reflected in the current forward rate of exchange. However, given the dynamic changes that take place in the world economic environment (uncertainty), it is likely that future [actual] spot rates will be different from the levels forecast for them by the current forward rates.

Implications for the Duty Issue

The first conclusion is that it will be a matter of indifference whether finance is raised in the domestic market, or whether funds are borrowed offshore and fully hedged, or whether the foreign currency loan is left unhedged. If the foreign exchange market is efficient, then in all three cases the expected cost of borrowing will be identical,[55] although one vital consideration will be the exposure to foreign exchange risk. In the first two cases the actual cost of borrowing is known and certain, whereas in the third the ultimate actual cost of finance is risky.

---

[52] Unbiased does not mean accurate in hindsight. Efficient markets can and do under and over react to the release of new information. Unbiased means that it will be impossible to systematically recognise under and over reactions as they occur over time. Hence, on average, it will not be possible to make profits from perceived misadjustments by the market.

[53] Supra at note 47, at 803.

[54] Ibid, 826.

[55] Ibid, 827.

The second conclusion relates to the efficacy of "selective hedging", a loan management process which was the subject of much debate in the Swiss Franc cases. Rather than fully hedging for the life of the loan, or remaining entirely uncovered, the loan is said to be managed by an active process of day-to-day monitoring of likely movements in the exchange rates. When it is perceived that the exchange rate will move adversely, the loan is hedged to eliminate or minimise the effect of the predicted movement. Otherwise the loan is left uncovered, allowing the borrower to benefit from lower interest rates and potential beneficial exchange rate movements. In this way, the objective is to earn windfall profits from upswings and yet be insulated from falls in the value of the domestic currency. For example, in *Lloyd v Citicorp (Australia) Ltd* it was suggested that:[56]

> Clearly, then, the way to manage a borrower's exposure is to hedge in times of volatility only and, if the borrower is fortunate, not only may there be protection against adverse movement in the currency but even a profit may be made.

The problem is to define what movements constitute unacceptable volatility in order to identify when to hedge and when it is "safe" to remain uncovered, given that "there is no scientific basis upon which accurate forecasts can be made".[57]

The effectiveness of an active management strategy fundamentally relies on the accuracy of exchange rate forecasts. However, if the foreign exchange market is efficient, current exchange rates will fully and instantaneously reflect all publicly available relevant information, including expectations. Thus, it will be impossible to systematically forecast movements in the spot rate. Technical analysis or charting which is based on historical exchange rate data will prove futile in the long run, as will analysis of economic fundamentals.

Empirical research suggests that the foreign exchange market is in fact informationally efficient. For example, a study based on forecasts (provided by Australian foreign exchange dealers and published in the Australian Financial Review) concluded that dealers were unable to make meaningful predictions. A simple assumption of a static exchange rate would have proved more accurate.[58] The "myth of speculative positioning"[59] applies equally to large banks and other financial institutions claiming instant access and constant contact with the market through dealing rooms and sophisticated technology employed to monitor fluctuations. A recent study by Oliver, Wyman & Co,[60] a strategic management consulting firm specialising in financial services, analysed sources of profits made by

---

56 (1987) 11 NSWLR 286, 296 (NSW SC).

57 Ibid, 287.

58 Lowe & Trevor, "The Performance of Exchange Rate Forecasts" (4th Quarter 1987) Australian Economic Review 31; noted by Rogers CJ in *Mehta v Commonwealth Bank of Australia* (1990) Aust Torts Reports 68,119, 68,126 (NSW SC).

59 Braas & Bralver, "An Analysis of Trading Profits: How Most Trading Rooms Really Make Money" (1990) Continental Bank Journal of Applied Corporate Finance, Vol 2, No 4, 85.

60 Ibid.

trading rooms:[61]

> Traders are naturally inclined to believe that the primary source of earnings in trading fixed income securities, equities, or foreign exchange is positioning. The underlying premise is that quality traders are able to predict the movements of interest rates, foreign exchange rates, and stock prices with sufficient accuracy to "beat the market" – if not consistently, then at least more often than not. Having analysed trading rooms around the world, for smaller operations in regional centers as well as major players, our experience suggests the above premise is ill-founded. For most trading rooms and traders, the financial markets are in fact very efficient, and betting on price movements is not a sound business proposition. Just as economists cannot consistently predict interest rates and mutual fund managers do not outperform the market year after year, traders cannot be expected to "outguess" movements in the value of trading instruments with any degree of reliability.

The second conclusion in relation to determining tortious duties of care is that market efficiency implies that it is impossible to systematically predict exchange rate movements. Thus, an active management strategy of "selective hedging" will have an expected value of zero. On average, the strategy will neither improve nor aggravate the situation and the exchange rate risk will continue to exist.

IV: NEGLIGENT MISSTATEMENT

The lender's duty to exercise care in relation to representations concerning the nature of a foreign currency loan will now be considered. Two situations must be distinguished in the Swiss Franc cases: (a) precontractual representations; and (b) the provision of advice, opinions, or information in relation to the management and monitoring of a foreign currency loan during its life.

(a) Precontractual representations and the Contractual Remedies Act 1979

Tortious liability for precontractual misrepresentations is almost entirely abrogated by s 6 of the Contractual Remedies Act 1979. Liability is dependent on meeting the terms of the statute. An examination of s 6 is beyond the scope of the present article, but it is worth noting those situations outside the ambit of s 6. The Act does not define "misrepresentation" and so the courts have applied the common law definition of a false or erroneous statement of an existing or past fact. Potential liability for a negligent omission to advise or warn during precontractual negotiations will therefore survive the Act. Omissions will be discussed later in this article.[62]

Negligent opinions which do not amount to a representation of fact will not be barred. However, it is submitted that such a situation will be rare. Opinions normally imply a representation that the opinion is actually held. Furthermore, if the speaker has expertise it will be inferred that the opinion could reasonably be held. Banks and bank managers are often perceived or held out as having greater knowledge and access to such expertise in relation to the foreign exchange market.

---

[61] Ibid.

[62] See text, infra at p46 and following.

An enquiry into whether an opinion was reasonably held is very similar to an enquiry as to whether the speaker breached a reasonable standard of care in forming the opinion.

(b) Representations outside the Contractual Remedies Act

The courts have not drawn a distinction between a negligent misrepresentation given in response to a request and a statement made voluntarily.[63] Liability for negligent misstatement has been based upon the existence of a "special" relationship of proximity, initially something "equivalent to contract".[64] The courts have seen this as necessary to counter the indeterminacy risk[65] of liability for economic loss:[66]

> Words are more volatile than deeds. They travel fast and far afield. They are used without being expended ...

In the Swiss Franc cases there were many examples of misleading statements made by lending officers along the lines that a foreign currency loan was "cheap money"[67] or which played down the foreign exchange risk. Many banks also placed advertisements in newspapers offering finance at low offshore interest rates without mention of the foreign currency risks.[68]

Standard of Care – the Approach in Other Jurisdictions

Of more interest is the standard of care which ought to be applied when statements are made in relation to the foreign exchange market. In relation to opinions and forecasts of likely market direction, or recommendations and advice as to selective hedging, the question is whether such statements can be reasonably based. Can forecasting meet a reasonable standard of care in an efficient financial market? This will determine whether it was reasonable for the bank to give the opinion or prediction, knowing that it would be relied on.

In considering the appropriate standard of care, the courts have recognised that the adviser is not an insurer and it is possible (particularly in relation to financial advice) to be careful but wrong.[69] The standard the courts have applied is the use of "skill and diligence which a reasonably competent and careful foreign exchange

---

63 *Shivas* , supra at note 41, at 368 per Tipping J; *Cornish v Midland Bank Plc* [1985] 3 All ER 513 (CA).

64 Supra at note 16, at 530 per Lord Devlin.

65 *Ultramares Corporation v Touche Niven* 174 NE 441 (1931).

66 Supra at note 16, at 534 per Lord Pearce, and at 482-483 per Lord Reid.

67 *David Securities Pty Ltd v Commonwealth Bank of Australia,* supra at note 42; see also infra at notes 75-77.

68 See Valentine, "Developments in Foreign Currency Loans Litigation" (1990) Australian Banking Law and Practice Conference 86.

69 See *Citibank NA v Stafford Mall Ltd,* supra at note 2, at 10. Conversely, the adviser, could be negligent but right. For a general expression of the standard of care of a bank manager as adviser see *Woods v Martins Bank Ltd* [1959] 1 QB 55, 73 per Salmon J.

[manager] would exercise".[70]

This must clearly be assessed in relation to the external circumstances and the situation in which the professional is operating. Mocatta J in *Stafford v Conti Commodity Services Ltd*[71] deals with this issue in response to an allegation by an investor of *res ipsa loquitur* as establishing negligence by a commodities broker for investment decisions made on the investor's behalf. After referring to a "notoriously wayward and erratic commodities futures market",[72] Mocatta J agreed with counsel's submission:[73]

> [A] broker cannot always be right in the advice that he gives in relation to so wayward and rapidly changing a market as the commodities futures market. An error of judgment, if there be an error of judgment, is not necessarily negligent any more than has recently been said in relation to an obstetrician in a very important case recently decided by the Court of Appeal (*Whitehouse v Jordan* [1980] 1 All ER 650) .... Furthermore, what is stated in that case is that the hazards of childbirth are such that the fact that a child eventually is brought into this world suffering from infirmities cannot by itself be relied on on the basis of the maxim res ipsa loquitur. Similarly, losses made on the commodity market do not of themselves, in my judgment, provide evidence of negligence on the part of a broker, even if he advised both parts of the particular transaction which produced the loss.

This was thought to be especially true because the matter was not within the sole management or control of the broker. The investor in that case often made his own decisions.

The nature of the market has impacted significantly on the reasoning employed by the Australian courts. It has been characterised as "purely speculative",[74] and "volatile and unpredictable".[75] The task of management has been described as "onerous and fraught with danger",[76] with foreign currency borrowing being similarly described as "basically a gamble"[77] and "unattractive to the timid and prudent".[78] In *Lloyd v Citicorp (Australia) Ltd* Rogers J said:[79]

> There is no scientific basis upon which accurate forecasts can be made of movements in currency. Although some operators in the market are better equipped to give advice than others, ultimately it is a gamble. It is a gamble because unpredictable factors may have immediate and violent repercussions. A rumour of the death of the United States President, the MX missile crisis, dismissal of an oil minister cannot be predicted or guarded against. Yet they may have immense impact on the foreign currency market. Deregulation has brought in its train volatility of proportions previously unknown. As in every true gamble, returns can be very high but so can losses.

This has led to difficulty in applying the traditional concepts of negligence law.

---

70 Supra at note 56, at 288.

71 [1981] 1 All ER 691 (QB).

72 Ibid, 696.

73 Ibid, 697.

74 *McEvoy v ANZ Banking Group Ltd* (1988) Aust Torts Reports 67,351, 67,355 (NSW SC).

75 *Chiarabaglio v Westpac Banking Corporation* (1989) ATPR 50,602, 50,624 per Foster J.

76 *Foti v Banque Nationale de Paris* (1990) Aust Torts Reports 67,835, 67,844 per White J (SA SC).

77 *Spice v Westpac Banking Corporation*, Federal Court of Australia, 1 September 1989, G49/87, p72 per Foster J.

78 *Commonwealth Bank of Australia v Mehta*, supra at note 42, at 92 per Meagher JA.

79 Supra at note 56, at 287-288.

Prudent or reasonable standards of conduct appear inept in a market where there seem to be only two kinds of participant: the quick and the dead. Rogers J notes:[80]

> Whilst it would have been helpful to have had some contemporaneous records beyond the ones available, to criticise [the forex dealer] on this basis is just as unrealistic in the foreign exchange market as to call for prudence. Speed is of the essence, the slow will be trodden over in the rush and will suffer losses ...

Earlier in the decision his Honour said:[81]

> It is sufficient for the present to point to the incongruity of identifying the duty in terms of confidence in the movements of the foreign exchange market or what a "prudent" financial adviser would or would not do in that market. It is somewhat akin to suggesting that an adviser to a player in a game of Russian roulette would tape up the firing mechanism, unless confident that there was no bullet coming into the chamber. Similarly, venturing into the foreign exchange market and from time to time becoming covered, that is hedged, or uncovered, that is unhedged, disqualifies the activity from having any relationship with any accepted notion of prudence.

This passage was cited with approval and applied in *McEvoy v ANZ Banking Group Ltd*,[82] *Davkot Pty Ltd v Custom Credit Corporation Ltd*,[83] *Chiarabaglio v Westpac Banking Corporation*,[84] and *Quade v Commonwealth Bank of Australia*.[85] Therefore, a very restrictive view of the content of the duty of care has been taken:[86]

> Whilst I am willing to accept, for the purposes of this case only, that the duty called for the exercise of skill and diligence which a reasonably competent and careful foreign exchange adviser would exercise, by reason of the nature of the market to which I have already referred, I would take leave to doubt that the content of that duty would be very high. That skill and diligence is of some assistance, I do not doubt. However, the assistance to be derived from it in a market as volatile as the one for the Australian dollar has been is fairly minimal.

Similarly, the evidential burden in *Stafford* was thought to be very high:[87]

> I am also satisfied that with the best advice in the world, in such an unpredictable market as this, it would require exceedingly strong evidence from expert brokers in relation to individual transactions to establish negligence on the part of the defendants.

It is for this reason that negligence actions for management and hedging advice have tended to fail.[88] This is also the source of the marked judicial reluctance to impose positive duties to offer such advice or to undertake to perform management services.[89]

---

80 Ibid, 290.

81 Ibid, 287.

82 Supra at note 74 (NSW SC); supra at note 35 (NSW CA).

83 Supreme Court NSW, 27 May 1988, No 12895/86, Comm D, pp123-124 per Wood J.

84 Supra at note 75; (1991) ATPR 53,257 (FCA).

85 Supra at note 42.

86 Supra at note 56, at 288 per Rogers J; see also *Chiarabaglio*, supra at note 75.

87 Supra at note 71, at 698 per Mocatta J.

88 See *Lloyd*, supra at note 56; *Stafford*, supra at note 71.

89 See *McEvoy*, supra at note 74; *Foti*, supra at note 76, at 67,844 per White J (although a duty was imposed in the special circumstances of this case); *Kullack*, supra at note 35.

A further factor influencing the level of duty is the sophistication or commercial experience of the client. In *Lloyd v Citicorp* it was stated:[90]

> It seems to me likely that the advice to be given to the treasurer of a multi-national incorporation in relation to dealing in foreign currencies will be minimal compared to that required to be given to a farmer in western New South Wales who, to the knowledge of the adviser, is entering the foreign exchange market for the first time.

However, the bank is not entitled to assume any significant knowledge of foreign currency transactions on the part of the borrower, but must actually know of the expertise.[91]

In applying the standard of care, the courts have adopted the approach of examining the evidence of other professional foreign exchange bankers and advisers. Expert witnesses have been asked to testify as to the likely market direction and volatility or risk at the time of each hedge transaction. They have also been asked to give opinions as to the course of action which a reasonable foreign exchange adviser would have adopted at the time or to outline the advice or forecast which they consider should have been given. The conflict of such evidence is usually noted,[92] and sometimes even relied on by the court as an indication of uncertainty giving rise to a duty to warn of the risks.[93] Whether a precontractual opinion as to the likely strength of the domestic currency is negligent, being essentially a forecast, is approached in a similar way to management advice.

In other situations the courts have tended to jealously guard the right to determine whether conduct amounts to professional negligence:[94]

> If it be found that a professional man does not use the degree of skill and care which the majority of his profession would have brought to the same task, then that is strong evidence of negligence .... At the same time ... the Court is not necessarily bound by such evidence for the Court must retain its own freedom to conclude that the general practice of a particular profession falls below the standard required by the law.

However, the Australian decisions are largely dependent on the industry standards of professional conduct in determining the legal standard of care and what constitutes "reasonable forecasts" or "reasonable management advice".

The Efficient Market and Implications for the Standard of Care

The problem with this approach is that such evidence is irrelevant in an efficient market. In an efficient market a "reasonable forecast" is a contradiction in terms, because it will not be possible to systematically forecast exchange rate movements.

---

90 Supra at note 56, at 288; accepted in *Davkot,* supra at note 83; see also *Spice*, supra at note 77, at pp57-59.

91 See for example *Spice,* ibid, where the plaintiff was a retired solicitor and property investor with considerable commercial experience.

92 Ibid, 67-68.

93 *Chiarabaglio,* supra at note 75, at 50,627 per Foster J.

94 *McLaren Maycroft & Co v Fletcher Development Co Ltd* [1973] 2 NZLR 100 (CA).

The implication is that a defendant can have no reasonable basis for opinions or forecasts, and hence for any management or hedging advice, which is not already impounded into current exchange rates. The value of a currency already reflects all publicly available relevant information in an unbiased manner. On this basis (unless the defendant had inside information) the plaintiff will always recover when the advice or forecast proves to be wrong, having suffered reasonably foreseeable loss in reliance upon the advice tendered.

Effectively this would result in the imposition of strict liability for forecasting, and hence for management and monitoring of the loan. The concept of a reasonable or prudent standard of care would appear to have vanished entirely. However, it seems inappropriate to determine in hindsight that a given action was negligent, simply because it turned out to be wrong. Current exchange rates are unbiased in an efficient market so that any advice to hedge, *however* formulated, will not be inferior to advice given against hedging. Thus, to assert that a given action was negligent simply because it turned out to be wrong seems inappropriate.

Citibank NA v Stafford Mall Ltd

Such criticism can also be directed at the first (and to date, the only) New Zealand Swiss Franc case, *Citibank NA v Stafford Mall Ltd.*[95] An offshore loan facility of the New Zealand dollar equivalent of $2,570,000 was arranged to finance a shopping mall development in Timaru. The first defendant, Citicorp Ltd, contracted to provide currency management advice (through its associate arm, Citicorp Forex Ltd). The loan was initially drawn down in US dollars in May 1985 but, due to substantial losses during the course of management, including a switch to Swiss francs, it was brought back onshore in July 1986 when the liability stood at NZ$3,044,000. The plaintiffs contended that none of the series of hedge contracts ought to have been entered into and that it would have been preferable to simply remain unhedged in US dollars throughout the entire period.

Both the High Court[96] and the Court of Appeal decided that the claim was for breach of a contractual duty to exercise the care and skill reasonably expected of a currency management expert with full knowledge of the contract between Citibank and Stafford Mall.[97] This standard is essentially the same as that which applies in negligence law and it is therefore useful to examine the Courts' reasoning on this point. In the High Court, Henry J began by remarking:[98]

> First, that it is an area in which the exercise of a special expertise is required (but also recognising that in the end the issues are to be decided on the whole of the evidence by the Court and not by the experts), and second, that there is now the very real benefit of hindsight.

---

95 Supra at note 2.

96 High Court, Auckland. 8 May 1991 CL 41/87 Henry J.

97 Ibid, p24; supra at note 2, at 10.

98 Ibid, p35.

Whilst the expert evidence was carefully scrutinised, and not always accepted, Henry J fell into the pattern adopted by the expert witnesses of considering the likely trends and forecasts surrounding each transaction. The recommendations and forecasts of the Citicorp advisory committee were referred to extensively, as was the language contained in the minutes of meetings. The references to "resistance points" and "support levels" suggest the use of technical analysis by Citicorp.[99] However, technical analysis is worthless in an efficient market because it attempts to extrapolate future price movements from perceived patterns in past price data. Such information should already be reflected in current prices.

Interpreting the contract terms "currency management advice" and "minimise the currency exposure", Henry J determined that the proper purpose of currency management was to protect the principal of the loan from adverse exchange rate movements. Applying an objective reasonable standard, the contractual obligation was to provide advice or recommend hedges which were reasonably required to keep the New Zealand dollar value of the repayment obligation from increasing:[100]

> The enquiry therefore into any particular forward contract under challenge is whether having regard to that purpose it was one reasonably prudent for Stafford Mall in the sense that it was needed to meet the future repayment of the principal and to gain protection against the possibility that the New Zealand dollar might fall against the loan currency.

The Court of Appeal shared this analysis of the standard of care required. In particular, the Court considered that the parties did not contemplate currency management directed towards making profits.[101] On this view, there would be no urgency in protecting gains made from favourable exchange rate movements. Thus, the exchange rate which prevailed when an individual borrower drew down the loan became an important reference point in determining whether it was reasonably prudent to recommend a particular hedge contract. Another factor which the Court considered to be important was the "top-up" clause. This required an immediate reduction of the loan to its original value in New Zealand dollars if exchange rate losses increased the total liability by 10%. It was therefore held to be an important objective of currency advice to minimise the risk of accumulated losses triggering a top-up demand.

The Court of Appeal affirmed Henry J's decision that Citicorp breached its contractual duty by making a global assessment of the market and issuing a blanket recommendation to all its customers.[102] The Court highlighted a number of factors which would affect individual customers differently. Citicorp disregarded the circumstances of individual customers in formulating advice, for example: the exchange rate applicable when the loan was drawn down; the length of time until the next roll over date or until repayment; the top-up risks; and the customer's cash flow position and other resources.

---

99 Ibid, p50.
100 Ibid, p29.
101 Supra at note 2, at 10.
102 Ibid, 19.

Critical analysis of Citicorp NA v Stafford Mall Ltd

It is submitted that the Courts' analysis of the issues is misconceived. The theory of interest rate parity demonstrates that the New Zealand dollar would have been expected to depreciate over the period, given that domestic interest rates were higher than those offshore in 1985-1986. Since selective hedging in an efficient market is futile, then *ex ante*, any such attempt to contain the New Zealand dollar value of the debt would have been speculative at best. Full hedging would have immunised the loan from exchange rate risk, but the forward premium paid would have resulted in a cost of financing equivalent to incurring the high New Zealand interest rates. This latter fact was recognised by Richardson J,[103] who noted that it was crucial for the commercial viability of the mall development that the cost of borrowing be reduced by taking a loan at the cheaper offshore rate. What his Honour did not realise, however, was that the expected financing cost was identical to that of borrowing unhedged because there would have been an expected exchange rate loss equal to the interest rate differential. The clear implication for Stafford Mall is that if the project was not viable at domestic interest rates, it would not have been viable by financing offshore:[104]

> The dreadful truth now confronting banks is that many broke a cardinal rule of foreign currency lending: if the borrower cannot service a debt according to local interest rates, he or she should not be lent money in foreign currency.

Furthermore, by accepting evidence of market trends and forecasts, the High Court and Court of Appeal judgments disregard market efficiency. In an efficient market, a defendant would be prevented from pointing to any factors, apart from those already reflected in the current exchange rate, upon which a forecast and recommendation could reasonably be formulated. Every decision which proves inaccurate in hindsight would fail the Courts' test, with the adviser being held strictly liable.

It is submitted that the imposition of a tortious duty to monitor and manage a foreign currency loan which arises merely from the professional relationship of bank and customer (and in the absence of a specific contractual undertaking) is unmeritorious – except in those circumstances where responsibility is clearly assumed. The test for proximity has evolved in the context of what is ostensibly a tortious duty, but in an efficient market it would amount to strict liability. It will be submitted that the duty of care owed to a customer ought to arise prior to the borrower agreeing to enter into a foreign currency loan.[105] Once undertaken, the borrower having been fully informed of all the risks, the lender is no longer liable for the consequences arising from the management of the loan.

---

[103] Ibid, 11.

[104] "The Swiss Loans Trap", *Business Review Weekly*, 12 September 1986, 20.

[105] See text, infra at pp46-53.

Consequences of applying a tortious standard of care

If the tortious standard were applied, a foreign exchange adviser could only be immune from liability in circumstances where the borrower is immune from any risks in exchange rate fluctuations. Thus, the only means of avoiding liability would be to fully hedge at the forward rate for the life of the loan. Support for this proposition can be gained from a recent New Zealand High Court decision, *Development Finance Corporation of New Zealand Ltd v Bielby*.[106] The defendant was a guarantor of a loan to a partnership which had invested in a New York play. The company formed to manage the partnership borrowed US$1.2 million from the plaintiff to finance the play. This case provides an excellent illustration of a natural hedge, thus being an appropriate situation for the use of a foreign currency loan, since the anticipated revenue was in US dollars. However, by January 1987 it was clear that the play was an unsuccessful venture so that the natural hedge no longer existed. In order to protect the loan from exchange rate risk, the management company hedged the loan until the time it was repayable in 1987. However, subsequent movements in the exchange rate meant that if the loan had not been hedged, but had instead been converted at the prevailing spot rate upon maturity in June 1987, the New Zealand dollar liability would have been $300,000 less than the amount payable (NZ$2.4 million) at the forward rate. The guarantor alleged that he was not liable for this "loss" under the terms of the guarantee covering "all outstanding indebtedness". Thus the decision turned on a construction of the contract and, in particular, on the issue of whether there was any implied authority for the company to enter into hedging contracts. In the course of the judgment, however, Thomas J endorsed the hedging decision as the reasonable prudent course to take in the circumstances, even though in hindsight it caused a greater loss:[107]

> [T]o leave the loan in United States dollars would have been more speculative than to convert it to New Zealand dollars .... The decision was principally based on the two factors; there would be no income stream in the United States, and the partnership would be exposed to fluctuations in the exchange rate which would or could be extensive. In my view, Mr Andreef made the prudently sound decision that it was in the partnership's interest to eliminate the risk of adverse foreign exchange movements, and that this was best done by meeting its United States dollar obligations in New Zealand dollars.

V: NEGLIGENT OMISSIONS - DUTY TO EXPLAIN, WARN, OR RECOMMEND INDEPENDENT ADVICE

In imposing positive duties, the law is concerned with striking a reasonable balance between a "laissez faire approach and one of undue paternalism".[108] The

---

[106] [1991] 1 NZLR 587 (HC).

[107] Ibid, 590.

[108] *Shivas*, supra at note 41.

Swiss Franc cases are not characteristic of situations of pure nonfeasance because there will always be a relationship between the parties as banker and customer. The concern is to define the limits of that relationship, and this will largely be a question of fact to be determined in the individual case.

Following the difficulties encountered by borrowers claiming negligent failure to manage a loan,[109] counsel changed tactics. Claims were brought on the basis that, had borrowers been properly advised of the complexity and risks involved in monitoring and managing such loans at the outset, they would not have entered into such transactions in the first place. Far from mitigating against a duty of care, everything previously acknowledged by the courts with respect to the speculative and risky nature of the foreign exchange market was used to endorse a duty to warn of the risks.[110]

Recent Case Law

In examining a duty to warn or advise, it is relevant to note at the outset that the bank/customer relationship rests primarily in contract. No duty arises merely by virtue of that relationship, nor is a loan contract *uberrimæ fidei* – of utmost good faith – requiring disclosure of all material facts.

However, some recent English authority appears to support the proposition of a limited duty to disclose in the case of guarantees.[111] In *Cornish v Midland Bank Plc*[112] the Court of Appeal developed some obiter statements of Sachs LJ made in *Lloyds Bank Ltd v Bundy*.[113] Kerr LJ commented (obiter) that banks may be under a duty in accordance with standard practice to proffer an adequate explanation as to the nature and effect of the document which the customer is about to sign.[114]

In New Zealand *Cornish* was initially well received. In *Shotter v Westpac Banking Corporation*[115] it was used to support a tortious duty to explain, warn or recommend independent advice in relation to guarantees. This approach was not followed in subsequent cases,[116] which raised doubts as to the existence of such a duty. The courts were influenced by the writing of Stuart Walker,[117] who put forward the view that the law already provided protection for a guarantor under the

---

109 See Rodgers, "Upon Whom Can You Bank?" (Sept 1989) 5 BLB 147.

110 *Chiarabaglio*, supra at note 75, at 50,624-50,625.

111 *Lloyds Bank Ltd v Bundy* [1975] QB 326 (CA); Affirmed in *National Westminster Bank Plc v Morgan* [1985] AC 686, 708-709 (HL) per Lord Scarman.

112 Supra at note 63; see also *Perry v Midland Bank Plc* [1987] Financial LR 237 (CA).

113 Ibid, 520 per Glidewell LJ; 521 per Kerr LJ.

114 Ibid, 522 per Kerr LJ; contra *O'Hara v Allied Irish Banks Ltd* [1985] BCLC 52, 53 (Ch D) per Harman J. See also *Davkot*, supra at note 83, at p116, where Wood J cites the *Cornish* decision in support of the existence of a duty to exercise care in relation to both the accuracy and sufficiency of disclosure.

115 Supra at note 41.

116 *Shivas*, supra at note 41; *Westpac Banking Corporation v McCreanor*, supra at note 41.

117 Walker, "Guarantees – Is There a New Duty on Banks?" [1988] NZLJ 319; see *Shivas*, ibid, 367 where Tipping J quotes from Walker's article.

equitable duty of unconscionability. It was argued that this doctrine was wider, that it provided better remedies, and that it was more flexible to protect the interests of an unfairly disadvantaged guarantor. Accordingly, it was considered that there was no "need" for tortious liability to be imposed on the lender.[118] With respect, such reasoning does not sit comfortably with the principles of tortious liability. The test for the existence of a duty of care is not governed simply by the issue of whether or not a duty is necessary, that is, whether or not there are any other remedies available. Furthermore, it is questionable whether the doctrine of unconscionability is adequate to protect the interests of a guarantor. The facts in *Shotter*[119] illustrate that tortious liability may arise in circumstances where unconscionability cannot be established.

Walker also argued that the importation of a tortious duty into the bank/customer relationship, which is essentially contractual in nature, is prohibited by the principle of concurrent liability.[120] However, it was acknowledged by Tipping J in *Shivas*[121] that liability in tort can arise in respect of matters which are antecedent to the formation of the contract. On this basis, it is submitted that a duty to warn or to explain prior to contract would not be precluded by this line of authority.

There are a number of other banking cases from around the Commonwealth which also *appear* to deny a duty to advise.[122] Furthermore, it has been argued in true floodgates fashion by Professor Valentine, an expert witness, that such duties ought not to be placed on banks. They create a moral hazard, enticing people to invest in risky situations knowing that banks will be liable to bear the loss incurred:[123]

> [W]hat stops [duties of care] from being extended to a whole lot of other areas of banking activity? Where is the end to the situation if you accept those ideas? Are banks going to be responsible for every loss ever suffered by their clients? If I borrow money to buy a house from a bank and then the price of that house drops because the property market turns down and I have to sell out at a loss, is the bank responsible for that?

With respect, Professor Valentine fails to distinguish between the investment and financing decisions. The cases denying a duty concern allegations of failure to advise on a transaction or investment decision for which the finance will be used.[124] That is entirely different from a duty of disclosure or explanation with

---

118 Walker, ibid, 323.

119 Supra at note 41.

120 Walker, supra at note 117, at 324. See *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1986] AC 80, 107 (PC) per Lord Scarman.

121 Supra at note 41, at 367.

122 For example, in *Williams & Glyn's Bank v Barnes* [1981] Commercial LR 205, the borrowed funds were applied in the purchase of shares which subsequently yielded a loss to the investor; see also *Redmond v Allied Irish Banks Plc* [1987] Financial LR 307 (QB); and *James v ANZ Banking Group Ltd* (1985) 64 ALR 347 (FCA), where the borrowed funds were applied in the purchase of farm land which failed to yield sufficient income to service the loan.

123 Supra at note 68, at 92.

124 See supra at note 122.

respect to the loan facility itself, which the bank has designed and marketed. In the Swiss Franc cases the foreign exchange risks are a result of the offshore finance provided by, and arranged under the control of the lender, and not the use to which the funds were put – which is an investment decision controlled largely by the borrower.

Application of the Duty Test in the New Zealand Context

The parties are in a bank/customer relationship negotiating a contract which places them in close proximity. There is no indeterminacy risk because there is contemplation of the precise plaintiff. Furthermore, the extent of the potential liability is monitored by the bank for the purpose of maintaining the value of any security interest. As was noted in *Downsview Nominees Ltd v First City Corporation Ltd,*[125] recognition of a duty is more readily accepted where the framework of a duty can be defined and limited. The bank has a pecuniary interest. Potential loss in the foreign exchange market is reasonably, if not clearly, foreseeable. Indeed, the ability of a bank to foresee the immediate risk highlights the proximity. It is therefore submitted that a special relationship of proximity and foreseeability, sufficient to support a duty of care, is present.

An important factor in the recognition of a duty is the relative degree of knowledge possessed by each of the parties. This impacts upon the extent to which a borrower may reasonably rely on the lender's expertise. In the Australian Swiss Franc cases a large number of internal policy documents, prepared by higher management and obtained from Westpac and the Commonwealth Bank of Australia, were tendered in evidence. Rogers CJ summarises the situation faced by Australian borrowers:[126]

> A picture has emerged, at least in some cases, of customers engaged in discussions concerning borrowing in a foreign currency, in the following setting:
>
> 1. The bank knew that such a borrowing was pregnant with the danger of large capital loss unless precautions were taken.
> 2. The bank knew that its staff was ill-equipped to explain the risk to the borrower.
> 3. The bank knew that staff was ill-equipped to explain the nature of the available precautions to be taken.
> 4. The bank was unwilling to accept the task of management even at a fee, and thereby undertake the task of implementing appropriate safety precautions as and when required.
> 5. The customer was unaware of the extent of the possible risk and of the available precautions which could be taken and the techniques for implementing such precautions.
> 6. The bank was aware of this lack of knowledge on the part of the customer.
> 7. The customer relied on the fact that the bank gave no warning of any of the foregoing matters. By reason of the omission to warn of the extent of the risk the customer relied on the belief that any risk was limited or slight.

Much judicial comment upon the banks' conduct in the light of this evidence has

---

[125] Supra at note 7.

[126] Rogers CJ, "Developments in Foreign Currency Loans Litigation" (1990) Australian Banking Law and Practice Conference 73, 77-78.

been scathing. In *Quade v Commonwealth Bank of Australia* Einfeld J said:[127]

> However, the strong if not overwhelming flavour of the documents was in firmly advantaging the bank through charging fees, and in fully protecting it by ensuring that adequate security, at whatever risk to the clients, was in place. The obvious clash of interests between the bank and its clients was strongly skewed towards the bank. There was no suggestion in any of the documents that this major conflict should itself be declared and explained to clients as a most important reason for the bank to decline to give any advice at all and to recommend and encourage them to seek and obtain competent independent advice .... [F]or the majority of its 1982/6 campaign to sell foreign currency loans, the bank had apparently been content to allow its clients to encumber or put at serious risk their assets, perhaps their life savings, as security for the bank without the slightest sense of urgency about remedying this most unsatisfactory approach to its obligations under the Trade Practices Act and the general law. In terms of risk, the emphasis was heavily on the bank's exposure and profits rather than the clients'. The clients' capacities to fund the consequences of adverse currency movements other than by the sale of basic assets were not even mentioned.

Reasonable reliance is primarily a question of fact to be decided in an individual case. There are conflicting views as to the extent to which borrowers do, or are entitled to, rely on their banks for information and advice. An example is *Quade* where, according to Einfeld J, a relationship of trust builds up in farming communities and bank managers can become "family advisers and 'father confessors' to their clients".[128]

Conversely, in many situations a bank is considered to be simply a supplier of a product, namely, credit:[129]

> [I]t should be recognised that for some time now the banker/customer relationship in Australia has been basically that of a vendor and purchaser of a commodity – money. For any number of reasons the personal relationship that used to subsist has substantially disappeared. It is fair to say that the erosion of the relationship has been replicated in the decreasing reliance placed by customers on their bank other than simply as suppliers of credit facilities.

However, the difficulty with reliance on an omission in situations of complete failure to disclose[130] is that the plaintiff obviously will not be aware that there has been an omission. The concept of reliance does become more meaningful where the disclosure was partial and incomplete. This is because the recipient may reasonably have relied on the explanation given, assuming that it was sufficient. It is submitted that a better approach would be to frame the duty in terms of a requirement that the borrower makes an informed decision to undertake the foreign currency loan facility. This approach is put forward in *Chiarabaglio*, where Foster J considered that an adequate explanation of the risks and nature of the product was germane to an informed decision as to whether to enter into the loan or not.[131]

---

[127] Supra at note 42, at 52,492; see also *Westpac Banking Corporation v Spice* (1990) ATPR 51,386, 51,394 (FC) per Sheppard J.

[128] Supra at note 42, at 52,499; see also the discussion in *Chiarabaglio,* supra at note 75, at 50,622-50,623, 50,624 per Foster J; and *National Australia Bank Ltd v Nobile* (1988) ATPR 49,233, 49,242-49,243 (FCA) per Davies J.

[129] Supra at note 126, at 74.

[130] See text, supra at p31.

[131] Supra at note 75, at 50,629.

It is the possession of superior knowledge and expertise by the lenders which places them in a position of control. A duty arises to exercise care that information provided is accurate, and to positively disclose information to an extent sufficient to ensure that the borrower is able to make an informed decision. Alternatively, the lender could discharge the duty by recommending that the borrower seeks an explanation and advice from an independent source.

The Australian case law highlights the extent of the lack of understanding on the part of borrowers and their advisers as to the interest rate parity relationship and market efficiency. The policy documents referred to earlier acknowledge that the loans were marketed to a segment of the public that was commercially unsophisticated with respect to foreign currency transactions. Examples include farmers and residential homeowners.[132] Even in the commercial sector it was known to the banks that the level of knowledge was generally poor.[133] The conflict and misunderstandings present in the expert testimonies given in the Swiss Franc cases indicate that accurate independent advice would not appear to have been readily available from other professionals, even if sought.[134]

It is proposed that the formulation of the duty by Wood J in *Davkot* would be the preferable approach for the New Zealand courts to adopt:[135]

> I am satisfied that as packager of a new and complex facility, Custom Credit did owe the plaintiffs a duty to exercise the skill and diligence of a prudent financier in respect of the transaction, extending to the supply of information which was both accurate and sufficient to enable Davkot, as an intending borrower, to make an informed decision whether to take it up or not.

The two most crucial factors of which borrowers ought to be informed are:

(i) that the expected cost of borrowing is identical in domestic and foreign markets. As discussed earlier, it will be a matter of indifference for the expected cost of funds whether finance is raised in domestic markets, or borrowed offshore and fully hedged, or left uncovered. The distinction is that the last option exposes the borrower to an unrewarded exchange rate risk of significant magnitude, which could result in large gains or losses. With the first two options the financing cost is known and certain; and

(ii) that an efficient foreign exchange market implies that systematic exchange rate forecasting is impossible. Therefore, management of the risks by selective hedging will not alter the expected cost of borrowing, once the cost of the hedge instrument is taken into account.

Such a duty can be criticised as commercially unrealistic, unfair and unreason-

---

[132] For example, *Mehta,* supra at note 58; *Kullack,* supra at note 35.

[133] *Quade,* supra at note 42, at 52,482.

[134] For example, in *Davkot,* supra at note 83, the accountant retained for advice was found to have known very little about foreign currency transactions.

[135] Ibid, pp117-118.

able[136] to impose upon a profit-making entity operating in a competitive commercial environment:[137]

> Where parties are dealing at arm's length in a commercial situation in which they have conflicting interests it will often be the case that one party will be aware of information which, if known to the other, would or might cause that other party to take a different negotiating stance. This does not in itself impose any obligation on the first party to bring the information to the attention of the other party, and failure to do so would not, without more, ordinarily be regarded as dishonesty or even sharp practice. It would normally only be if there were an obligation of full disclosure that a different result would follow. That could occur, for example, by reason of some feature of the relationship between the parties, or because previous communications between them gave rise to a duty to add to or correct earlier information.

The bank must assess the prudence of lending, bearing in mind the obligation it owes to its shareholders.[138] The bank's concern as to the customers' prosperity is not altruistic, but arises from its own self-interest in the customers' ability to repay. To impose duties of rescue in such situations could be viewed as imposing an obligation of "nursemaid" on professionals:[139]

> Frankly, the imposition by courts of duties which the parties only dream up when their lawyers get into the act long after the event is a matter which ought to be discouraged. If a customer is going into a major undertaking he [or she] ought not to look to anybody he happens to deal with (his lawyer for conveyancing, his accountant for accounting purposes, his banker for money) and suggest that they should gratuitously advise on the risks or absence of wisdom in the proposal. Certainly the banker who is asked only to lend money (on his hypothesis) should be looking to his own interests – can it be repaid?

The solution to this problem is that the lender's commercial interests can be balanced by defining the scope of the duty. In *Lloyd v Citicorp (Australia) Ltd*[140] Rogers J expressed the view that the information called for, in discharge of the duty, properly differs according to the known commercial sophistication and knowledge of foreign currency dealings on the part of the borrower. Thus, where the lender is truly in arm's length negotiation, such as in the case of the treasurer of a multinational corporation experienced in foreign currency debt, the bank's concern to protect its own interest need not be circumscribed.[141]

Also, the duty only extends to disclosure of information. The decision is left entirely to the borrower, who can then make up his or her own mind as to the wisdom of the transaction or seek professional advice, based on accurate information and explanations. Wood J clarifies this in *Davkot*:[142]

> I would not go so far in the instant case as to hold that Custom Credit should have advised the plaintiffs not to take up the facility. That would be excessive and commercially unrealistic. On my assessment, the duty was one requiring Custom Credit to place the plaintiffs in a position where

---

136 Fairness and reasonableness are part of the *Downsview* test for recognition of a duty of care.

137 *Lam v Ausintel Investments Australia Pty Ltd* (1990) ATPR 50,866, 50,880 (NSW CA).

138 See Valentine, supra at note 68, at 90-93.

139 Kriewaldt, "Foreign Currency Transactions - Liability for Negligent Advice" (1988) Australian Banking Law and Practice Conference 221, 236.

140 Supra at note 56, at 288.

141 *Spice*, supra at note 77, at p58.

142 Supra at note 83 at p118.

> they were sufficiently informed as to the transaction ... [and] as to the potential benefits and risks attaching to what was a novel facility which might qualify its apparent advantages, so as to permit an informed decision.

It is therefore submitted that the duty is not unduly onerous and that it is sensitive to the commercial needs of the situation.

VI: CONCLUSION

The Australian experience in relation to the negligence claims of foreign currency borrowers demonstrates a lack of understanding by the commercial community, borrowers in general and, with respect, by the courts.[143] The concepts of interest rate parity, efficient capital markets and principles of international finance have been overlooked in the search for tortious liability. This is especially evident where the Australian courts have imposed the traditional reasonable and prudent standard of care upon advisers attempting to forecast exchange rate movements and implement loan management strategies.

Similarly the *Citibank* case illustrates that the New Zealand courts have not formulated an appropriate standard of care for foreign currency advisors. It is submitted that the New Zealand courts should only impose a duty of care on a lender introducing a complex new financing facility prior to contract. The elements of the duty test can be established: parties negotiating a foreign currency loan contract are in a highly proximate relationship; foreign exchange losses are reasonably foreseeable; and the obligation imposed upon lenders does not expose them to a risk of indeterminate liability. *Citibank* is currently on appeal to the Privy Council. It is hoped that their Lordships will recognise the principles of international finance central to a proper understanding of the foreign exchange market in interpreting the contractual duty in the Citicorp currency management agreement.

The concept central to the tortious duty proposed in this article is to explain and provide information sufficient to enable a borrower to make an informed decision or to obtain independent expert advice. Such an explanation need not be derisive of the product, but simply accurate. No duty of care ought to be imposed after the contract has been entered into. The duty advocated is fair and reasonable because it is flexible. It allows a court to prevent abuses of the position of knowledge and control enjoyed by the lender, while being sensitive to the commercial interests of the bank. Furthermore, the duty is tailored to the known commercial sophistication and foreign exchange expertise of the client borrower. In fact, the duty will ultimately yield benefits to the lender, enhancing as it does the likelihood of repayment. This is because informed borrowers are able to select financing products relevant to their needs, and thus to avoid obligations beyond their means.

---

[143] The better judgments are those of Wood J in *Davkot*, supra at note 83; Foster J at first instance in both *Spice*, supra at note 77, and *Chiarabaglio*, supra at note 75; Rogers CJ at first instance in *Mehta*, supra at note 58; see also a paper by Chief Justice Rogers, supra at note 126.