Privy Council Appeal No. 58 of 1992

Citibank N.A. *Appellant*

v.

Stafford Mall Limited *Respondent*

FROM

THE COURT OF APPEAL OF NEW ZEALAND

JUDGMENT OF THE LORDS OF THE JUDICIAL COMMITTEE OF THE PRIVY COUNCIL, DELIVERED THE 16TH NOVEMBER 1993

Present at the hearing:-

LORD KEITH OF KINKEL
LORD BROWNE-WILKINSON
LORD SLYNN OF HADLEY
LORD LLOYD OF BERWICK
SIR THOMAS EICHELBAUM

*[Delivered by **Lord Lloyd of Berwick**]*

This case arises out of a Currency Management Agreement dated 8th July 1985 between the appellant, Citibank N.A., and the respondent, Stafford Mall Limited, a company incorporated in New Zealand who were the plaintiffs in the action. The case came on for hearing before Henry J. in the High Court of New Zealand on 12th March 1991. After a trial lasting 18 days, the judge found in favour of the plaintiffs. He awarded $546,367 as damages for breach of contract, plus interest. An appeal to the Court of Appeal was dismissed on 10th June 1992. There is now an appeal by leave to Her Majesty in Council.

The plaintiff company was formed for the purpose of promoting and developing a shopping mall at Timaru, in the South Island. The company is or was owned and controlled by Mr. Edginton, a successful local businessman. At the time of the proposed development, interest rates in New Zealand were over 20%. If the project was to be viable, it was essential that the company should be able to borrow at a lower rate of interest. Accordingly, the company entered into what is known as a multi-currency loan agreement, whereby the bank agreed to lend the company the equivalent of NZ$2,570,000 in U.S. dollars, or in one or more other currencies freely convertible into U.S. dollars. The agreement is dated 21st

May 1985. The initial loan, known as the development loan, was to be replaced by a term loan expiring on 30th August 1990. Interest on the term loan was at 2% above a Singapore bank rate known as SIBOR. This was less than half the current New Zealand rate of interest. Interest was payable at three monthly intervals. The loan was "rolled over" at the end of each interest period.

The loan was drawn down in four tranches. The first draw down was on 20th May 1985 at a spot rate of .45, i.e. 45 U.S. cents to the New Zealand dollar. The second draw down was on 20th June at .47. The third draw down was on 23rd July at .51. The final draw down was on 2nd August at .53. So the New Zealand dollar was strengthening against the U.S. dollar throughout the draw down period. The total sum drawn down was U.S.$1,228,614. The average draw down rate was .478.

Another important feature of the New Zealand economy at the time was that the exchange rate was extremely volatile. Until 1985 New Zealand had a managed currency. The exchange rate was strictly controlled. When exchange control restrictions were lifted in March 1985, and the New Zealand dollar was allowed to float, the rate was about .44. It was generally assumed that the rate would fall below that level, due to a net outflow of capital. In the event this did not happen.

In order to protect itself against the expected fall in the value of the New Zealand dollar (thus making it more expensive for the company to repay the loan) the company entered into a second agreement with the bank known as the Currency Management Agreement. It was dated 8th July 1985. The purpose of the Agreement, as its title would suggest, was to provide the company with advice on the management of the currency aspect of the loan. Since the outcome of the appeal turns on the true construction of the Currency Management Agreement, it is appropriate to set out the relevant terms verbatim, as did the judgments in the courts below:-

"WHEREAS

A. The Bank has provided the Borrower with a multi-currency credit facility (hereinafter called 'the facility') amounting to NZ$2,570,000 (hereinafter called 'the amount of the facility') upon the terms contained in a facility agreement made between the parties and dated the 21st day of May, 1985 (hereinafter called 'the agreement') and at the request of the Borrower has agreed to offer the Borrower currency management advice in respect of the facility and may at its sole discretion offer to the Borrower certain currency information (as hereinafter defined) from time to time.

B. The Borrower may request the Bank to provide the Borrower with spot or forward exchange contracts (hereinafter called 'forward contracts') to minimise the currency exposure of the Borrower in respect of the facility.

C. As a precondition to considering any such request the Bank has required the Borrower to enter into this Deed to confirm the terms upon which the Bank at its discretion may enter into forward contracts or may procure its related company CITICORP FOREX LIMITED duly incorporated company having its registered office at Auckland (hereinafter called 'Citicorp Forex') to enter into forward contracts.

D. In addition to (sic) the Bank and the Borrower wish to record the effect which a currency movement may have on the amount available for drawing under the facility.

NOW THEREFORE THIS DEED WITNESSETH AND IT IS HEREBY AGREED AND DECLARED BY AND BETWEEN THE PARTIES HERETO as follows:-

1. IN the event that the Borrower shall request the Bank to provide or procure Citicorp Forex to provide, the Borrower with forward contracts to minimise the currency exposure of the Borrower in respect of the facility, the provision of such forward contacts (sic) shall be at the sole and absolute discretion of the Bank and upon such terms as the Bank or Citicorp Forex shall from time to time require.

...

3. THE following terms and conditions shall be deemed to form part of every forward contract unless the parties expressly agree in writing to the contrary and shall have effect severally in respect of all forward contracts whether entered into before or after the date of this Deed:-

(a) all losses, costs, fees and other moneys which may become payable by the Borrower to the Bank and/or Citicorp Forex pursuant to each forward contract shall be deemed to form part of the facility and be owing under the agreement, and accordingly secured by the securities (if any) which have been issued by the Borrower in favour of the Bank as security for the facility and which are more particularly defined in the agreement:

...

4. ...

(b) In the event that at the end of any Interest Period the aggregate of all drawings under the agreement exceeds by 10% or more the amount of the facility (or such lesser sum to which the amount of the facility has at the end of that Interest Period been reduced in terms of the agreement) then the Borrower will on the last day of that Interest Period repay to the Bank in the currency in which Advances were made during that Interest Period (or if those Advances are denominated in more than one currency, then in those currencies in the proportions which the amount of those Advances denominated in those currencies bears to the total amount of the Advances) such an amount as will result in the aggregate of all Advances not exceeding the amount of the facility (or such lesser amount as aforesaid) AND for the purposes of this clause the aggregate of all Advances shall be determined in the manner provided in that part of the agreement dealing with the calculation of currency equivalent in respect of Advances.

...

7.(a) DURING the continuance of the agreement and for so long as the Borrower shall have paid the annual fee specified in sub-clause (c) of this clause, the Bank shall provide the Borrower with currency management advice in respect of the facility.

(b) The Borrower shall pay the Bank an annual fee of $5,000 in consideration of the Bank providing such currency management advice, such fee to be payable annually in advance;

(c) In addition to the management advice to be provided by the Bank in terms of sub-clause (a) of this clause, the Bank at its sole and absolute discretion may from time to time provide, or procure Citicorp Forex to provide the Borrower with advice, information and data on currency movements, currency swaps, spot or forward exchange cover and monetary forecasts and trends, provided that any such advice, information and data (hereinafter in this clause called 'currency information') shall be supplied or made available expressly upon the terms and conditions specified in this clause;

(d) The Borrower acknowledges the inherently speculative nature of any advice or data relating to anticipated currency movements and trends and accordingly agree that should it in any way act in reliance upon the currency

> information, it shall do so entirely at its own risk and neither the Bank nor Citicorp Forex shall be liable in either contract or tort for any loss or damage (whether financial or otherwise) which may be suffered either directly or indirectly by the Borrower, as a result of the Borrower relying in whole or in part upon such currency information."

It will be noticed that the obligation under clause 1 was conditional on the borrower requesting the bank to provide forward contracts. However by letter dated 30th September 1985 Mr. Edginton, on behalf of the company, authorised the bank to enter into forward contracts, and to act generally in accordance with the recommendation of the bank's Foreign Exchange Advisory Committee without further reference to him.

The importance of clause 3(a) is that any losses made by the company on forward contracts were to be added to the principal debt, and "to be deemed to form part of the facility". Likewise any profit made on a forward contract was deducted from the principal. That this is what in fact happened can be seen from the monthly summary reports, copies of which were sent to the company.

The importance of clause 4(b) is that it contains the so-called "top-up" provision. If at the end of any interest period the amount outstanding, including accumulated losses, should exceed 110% of the original loan, the company was obliged to repay the difference. Expressed in New Zealand currency, at the commencement of the loan, the "top-up" point was NZ$2.82 million.

Their Lordships turn next to consider the way in which forward contracts were intended to operate. The bank's Foreign Exchange ("Forex") Advisory Committee met weekly. If it advised that the New Zealand dollar was likely to fall against the U.S. dollar, thereby increasing the borrower's repayment obligation at the next rollover, the borrower could protect himself by "hedging", that is to say, by locking into the existing rate. This was done by the parties buying and selling the amount to be hedged at a forward rate. The forward rate was always equal to the existing rate, but reduced by a formula based on the difference between the current U.S. rate of interest and the current New Zealand rate of interest over the agreed period of the hedge. This period was always to the next rollover date. If on that date, or whenever the hedging contract was closed, the spot rate was the same as the forward rate, there would be no "gain" or "loss". The only cost to the borrower would have been the difference between the two rates of interest. This is what he would have had to pay anyway if he had borrowed in New Zealand dollars instead of U.S. dollars. If, as expected, the spot rate at closure was lower than the forward rate, he would be fully protected, even if the fall in the New Zealand dollar was

catastrophic. If, however, the spot rate on closure was higher than the agreed forward rate, the borrower would suffer a "loss". But since, ex hypothesi, the New Zealand dollar would have strengthened, his repayment obligation on rollover would be correspondingly reduced. Thus, if the hedging contract ran its full length, the loss on maturity would be exactly balanced by the reduction in the customer's liability to repay.

Looked at it in that way, "gains" and "losses" on hedging contracts were notional. The purpose of hedging was, quite simply, to eliminate the foreign currency risk for a limited period of time, by bringing the loan temporarily "on shore". The cost, for obvious reasons, had to be the difference between the two rates of interest, since otherwise the bank which was, in effect, lending in New Zealand dollars for the period of the hedge, would have been to that extent out of pocket.

The history of the transactions between the parties subsequent to draw down is fully set out in the judgments below. It is unnecessary to repeat the history in detail. The minutes of the Forex Advisory Committee paint the picture. Thus on 29th July, very shortly before the last draw down, one finds:-

> "An extremely volatile week. The NZD touched a peak of 53 cents before declining to a low of .5030 on Friday afternoon. It settled at a level of .5130 and after initial selling today from its London levels of .5180 is now trading at similar levels.
>
> The extreme volatility in the NZD last week reflects the market's nervousness when the large selling orders hit the market. Solid support is found below 51 cents and we expect this to remain in the short term. The large and rapid decline once again reinforces the belief that any large scale selling of the NZD by either importers or offshore borrowers will cause a sharp and dramatic decline in the NZ currency."

On 26th August one finds:-

> "The NZD declined steadily last week with little interest from Europe ...
>
> Sufficient evidence is now available to indicate a change in the NZD uptrend and consequently it is recommended that our subscribers cover the Kiwi dollar/U.S. dollar position by selling Kiwi dollar forward until the next rollover date. At maturity of the forward contract, the realised gain or loss will be offset against the underlying loan liability ..."

It was as a consequence of this recommendation that the loan was hedged for the first time. The date of the forward contract was 26th August and it was closed out on 26th September at a "loss" of $53,089. But as the relevant minute correctly points out the loss was offset by an equivalent reduction in the underlying loan liability at rollover.

On 16th September the Forex Advisory Committee believed that a downward correction in the New Zealand dollar was imminent. Throughout November the recommendation was that New Zealand borrowers should remain fully hedged, although this would, as was recognised, be "very very expensive" because of high domestic interest rates. Then in December the long-expected decline occurred. It started on about 11th December. The minute of 16th December describes the following week as traumatic. The New Zealand dollar "plummeted" against all major currencies and "collapsed" to a low of .482, only just above the average rate of draw down, and well below the draw down rate of the third and fourth tranches. But the company was fully protected against this sudden collapse, and forward contracts made on 29th November and 17th December resulted in a "profit" to the company of $41,816 and $107,528 respectively.

The bank continued to follow the recommendations of the Forex Advisory Committee during the first half of 1986.

On 26th March 1986 the Forex Advisory Committee advised that there was potential for a sharp downward movement in the New Zealand dollar. On the other hand the U.S. dollar had reached the bottom of its very rapid decline, and was thought likely to strengthen against all major currencies, and in particular against the Swiss Franc and the Deutschmark. Accordingly the Forex Advisory committee recommended a switch out of U.S. dollars into Swiss Francs. This was done at rollover on 7th April 1986. However, contrary to expectations, the Swiss Franc strengthened, and the loan was hedged back into U.S. dollars on 9th April, for a "gain" of $79,829. The underlying currency of the loan remained Swiss Francs.

By the middle of June the New Zealand dollar had declined to about 52 cents from a high of 58 cents. On 7th July the loan stood at NZ$3,044,000, which was well above 110% of the original loan of $2.57 million. The company was unable to comply with its obligation to "top-up". Accordingly the loan was brought on shore. The New Zealand dollar continued to decline throughout July and August, reaching a low of 48 cents on 22nd August.

So much for the history. In summary there were 15 hedging transactions in all. Nine resulted in "losses" and six resulted in "gains". It is common ground that the bank followed the advice of the Forex Advisory Committee throughout.

Their Lordships now turn to the expert evidence. Mr. Duncan, the Treasurer of the National Bank of New Zealand, the expert witness called on behalf of the bank, considered each of the 15 hedging transactions against the background of the relevant minutes. In his evidence he said:-

"I have been asked to advise if it is now possible to say whether any of the forward contracts which Citi entered into on SML's behalf were unnecessary. I am satisfied that on the information recorded in the Committee's minutes all transactions were rational and soundly based and could be classified as necessary to protect SML's position at the relevant time. There is no hint of speculation or inconsistency. It is very important that SML's forward contracts were always written to the next rollover date of its loan without any indication that they were written with the intention of being closed out beforehand."

The judge found Mr. Duncan to be a "knowledgeable, intelligent and coherent witness". And he accepted the thrust of his evidence that the transactions were soundly based. But he rejected Mr. Duncan's conclusion, because in the judge's view Mr. Duncan had misconstrued the bank's obligations under the contract.

As for Mr. Rush, the plaintiffs' expert witness, the judge found himself in a difficulty, since in cross-examination he resiled on a number of occasions from the view which he had expressed in chief. Thus in relation to the forward contract made on 26th September 1985 which resulted in a "loss" of $87,000, Mr. Rush accepted in cross-examination that the action taken by the bank was "not inappropriate". Although he went back on this in re-examination, the judge felt bound, very properly, to regard his evidence on that matter as equivocal. Yet he held that the forward contract in question was not reasonably required to protect the company's position. Even if one disregards Mr. Duncan's evidence altogether, it is not clear to their Lordships how, in the absence of unequivocal expert evidence from Mr. Rush, he was entitled to take that view.

That brings their Lordships to the central issue in the appeal. The respondents' case before the Board was substantially the same as their case in the courts below. It involved two steps.

(1) The bank's duty under clause 7(a) was to provide the customer with currency management advice. That was a duty which the bank owed to each customer individually. Accordingly the bank was bound to have regard to the customer's particular circumstances. It was not enough for the bank to deal with its customers as members of a pool, or to pass on recommendations from the Forex Advisory Committee without considering whether the recommendation was appropriate to the particular customer.

(2) Among the particular circumstances of the company known to the bank were (a) that it was short of resources, and would therefore have difficulty in meeting its obligation under the "top-up" provision in the event of the loan exceeding 110% of the original figure, (b) that the loan had been drawn down at an average rate of .478, (c) that the New Zealand dollar was strengthening against the U.S. dollar during the period of the draw down, (d) that at the

time of the first hedging contract on 26th August 1985 the rate stood at .54 and (e) that it remained between .52 and .59 throughout September, October, November and the first ten days of December. It was contended that the risk of the rate falling back to below .478 was minimal, and should have been disregarded. No prudent adviser would in those circumstances have advised the company to hedge the loan, bearing in mind the risk that the company might incur a loss on the hedging contract and that any loss so incurred would be added to the amount of the loan, and bearing in mind the primary purpose of the Currency Management Agreement which was, so far as the company was concerned, to protect, and protect only, the amount of the original loan.

Henry J. accepted both steps of the respondents' argument. Their Lordships quote some passages from his judgment to illustrate his approach:-

> "I turn now to what is really the crucial issue in the whole proceeding, namely, whether the challenged transactions or any of them were reasonably required for Stafford Mall having regard to the primary purpose of keeping the New Zealand dollar value of the loan from exceeding $2,570,000. ...
>
> The real risk to be guarded against, as I have said, is not just the consequence of any adverse movement which is forecast in the course of the management period but the consequence of that movement increasing the original exposure. The need for forward contracts is to eliminate, so far as it can be done, the risk of that exposure from 'blowing out' so that the benefit of the low interest rate obtained by borrowing offshore is not nullified. To confine consideration of entering into a forward contract to whether or not there may be an adverse movement and nothing more is to ignore, as a factor, whether the risk of that movement and its perceived likely extent outweighs the risk to the borrower inherent in the contract itself. It also ignores consideration of whether the original figure, the protection of which was the base purpose of management, is itself at risk. ...
>
> Put shortly, I can see no justification for construing Citibank's obligation under this agreement as entitling it to disregard the original loan figure, which in effect is what is suggested should be done."

The Court of Appeal adopted Henry J.'s analysis, and repeated with approval all the passages quoted above.

Their Lordships would also quote the following summary of the respondents' argument in the Court of Appeal:-

"Mr. Farmer, for Stafford Mall, then submitted that the programme of hedging recommended and instituted by Citibank for Stafford Mall was inappropriate to Stafford Mall's circumstances, once the New Zealand dollar had strengthened appreciably against the U.S dollar from its drawdown level (as it had done before the first hedge) so that the risk of top up became remote. In those circumstances, and having regard to the fact that Stafford Mall could not bear either the costs of hedging on a more or less continual basis (because that was equivalent to the cost of borrowing domestically) or the risks of incurring losses that were immediately brought to account (because that would quickly threaten the top up level), Citibank as a reasonably careful and skilled foreign exposure manager ought to have taken a longer term view of currency trends and left Stafford Mall unhedged."

It was this argument which the Court of Appeal in effect adopted.

Their Lordships have no difficulty in accepting the first step in the respondents' argument. Although the annual fee payable under the Currency Management Agreement was very modest, the company was entitled under clause 7(a) to advice in respect of its facility. It was not enough for Mr. Manning, the account manager, to say as he did that he acted like a conduit pipe, passing on generalised recommendations from the Forex Advisory Committee, without considering whether they were appropriate to the company's particular circumstances. It may well be that Mr. Manning was not himself equipped to carry out that function. But that cannot affect the bank's obligation under the agreement. Their Lordships agree with what has been said in the courts below on this aspect of the matter.

But it by no means follows that the advice in fact given from time to time, and the steps taken in consequence of that advice, were in breach of contract, on the ground that it was advice which no reasonably prudent currency management adviser would have given. As already mentioned, Henry J. accepted the thrust of Mr. Duncan's evidence that each of the forward contracts was "logically based on a reasonably assessed evaluation of the likely movements of exchange rates". The judge only rejected the inevitable consequence of that evidence because in his view Mr. Duncan had misconstrued the contract. In the judge's view, the primary purpose of the contract was not to guard against adverse movements in the exchange rate from time to time during the currency of the agreement, as Mr. Duncan had said, but only when the original loan figure was under threat. It was only when the amount of the loan was "fairly close to the original loan figure" (to use the language of the Court of Appeal) that the bank should have advised the company to enter into a hedging contract; not when it was "substantially above" that figure (to use the language of the judge).

Their Lordships are unable to agree with this approach. It is not justified by the express language of the contract, and their Lordships do not see how any such limitation on the scope of the advice to be given by the bank can be implied. Indeed the indications from other provisions of the contract are the other way. Thus it appears from paragraph B of the Recitals and clause 1 of the Agreement, that the purpose of entering into forward contracts was to "minimise the currency exposure of the Borrower in respect of the facility". The "facility" here must mean the facility as existing from time to time. It is not confined to the original loan, as one can see, for example, from clause 3(a) which provides for losses on forward contracts to be added to, and to be deemed to form part of, the facility.

Was the judge's approach justified having regard to the fact, known to the bank, that the company was short of resources, and would therefore have difficulty in meeting the "top-up" obligation? If the purpose of entering into hedging contracts had been the chance of making a profit, in other words if the purpose had been purely speculative, then of course the company's lack of resources would have been very relevant. But that was never suggested. The purpose was always to guard against an adverse movement in the exchange rate. This would inevitably make it more expensive for the company to repay, and might at any time take the amount of the loan above the "top-up" point. The consequences of an adverse movement, whether sudden or sustained, were no doubt more serious for the company because of its lack of resources. But the degree of risk was the same as for any other borrower. The seriousness of the consequences would, one might think, make it more, not less, desirable to guard against any adverse movement in the rate. In the course of a passage already quoted from the judge's judgment he said:-

> "To confine consideration of entering into a forward contract to whether or not there may be an adverse movement and nothing more is to ignore, as a factor, whether the risk of that movement and its perceived likely extent outweighs the risk to the borrower inherent in the contract itself."

With respect, their Lordships find difficulty in understanding this observation. The risk of any adverse movement, and the risk inherent in entering into the contract itself, should the movement prove to be favourable, are two sides of the same coin. How then can they be weighed against each other?

For the above reasons, their Lordships do not agree with the courts below that Mr. Duncan misunderstood the bank's contractual obligations, or that he applied the wrong test. It follows that if his evidence as to the individual transactions was otherwise preferable to that of Mr. Rush, as the judge appears to have thought, the

courts below should have accepted the consequences of that evidence, and dismissed the claim. A test which depends on whether the spot rate was "substantially above" or "fairly close" to the average draw down rate would introduce a needless element of uncertainty into an ordinary commercial contract.

But let it be supposed that there might have come a point when the exchange rate was so far above the average draw down rate, and the amount of the loan was so far below the "top-up" point, that no prudent adviser would have advised the company to enter into a hedging contract, no matter what the recommendations of the Forex Advisory Committee as to future movements of the exchange rate: what then?

Their Lordships have already referred to the minutes of the Forex Advisory Committee between July and September 1985. It was thought, with reason, that a downward correction in the New Zealand dollar was imminent. When the correction came in December, the rate fell 8 or 9 points within a few days. If that correction had occurred as expected at the end of August, when the loan was hedged for the first time, then the resulting fall would have taken the rate below .47, and well below the rate at which the third and fourth tranches were drawn down. If, having received the recommendation of the Forex Advisory Committee, the bank had failed to hedge the company's liability, the company would no doubt have been the first to complain, especially if the bank had hedged the loans of other borrowers. How then can the bank be blamed because the expected fall did not materialise until three months later? The judge accepted that the hedging contracts entered into on 17th December and 31st December were not unreasonable, apparently because a sharp fall had already occurred, and a further fall was likely. But the art of good foreign currency management consists in locking the stable door before the horse has bolted. This is what the bank advised the company to do at the end of August and again in September. Their Lordships are unable to agree that that advice was such as no prudent adviser would have given. Even if, contrary to their Lordships' view, the judge's construction of the contract was correct, and he was entitled to disregard Mr. Duncan's views (as to which Mr. Duncan was never cross-examined), there was no evidence to support the judge's conclusion other than that of Mr. Rush, whose evidence on this particular matter (i.e. the September contract) the judge himself regarded as equivocal.

The judge was, as he said, fully alive to the dangers of hindsight. Regretfully it must be said that that is the very trap into which he fell.

The Court of Appeal appear to have accepted the company's argument that the bank ought to have taken a longer term view of currency trends, and left the company unhedged. But as has already been pointed out, it was generally assumed in March 1985, when the New Zealand

dollar was floated, and thereafter, that the rate would eventually settle down below .44. Even if one ignores the short term fluctuations, it is not easy to see how, in the absence of hindsight, the bank can be criticised for its long term view.

As an alternative, the bank argued that the appeal ought, in any event, to be allowed in respect of losses resulting from the switch into Swiss Francs in April 1986. Their Lordships formed the view that the appellants' arguments under this head were unanswerable. But since they are entitled to succeed on the main ground, it is unnecessary for them to state their reasons.

For the above reasons their Lordships will humbly advise Her Majesty that the bank's appeal ought to be allowed, that the judgments of the Court of Appeal and Mr. Justice Henry be set aside and the action dismissed, and that the respondent ought to pay the appellant's costs in the Court of Appeal and in the High Court. The respondent must also pay the appellant's costs before their Lordships' Board.