Under the influence

The bar for establishing claims of undue influence & unconscionable bargain remains high, say Nicholas Fidler & Emily Tearle

IN BRIEF

▶ In circumstances where commercial parties transact with each other, the courts remain reluctant to intervene, even in circumstances where, on the face of the transaction, one of the parties is disadvantaged.

The recent High Court Chancery Division judgment in *The Libyan Investment Authority v Goldman Sachs International* [2016] EWHC 2530 (Ch), [2016] All ER (D) 120 (Oct) provides a useful reminder of the law of undue influence. It confirms that the bar for establishing such a claim remains high for commercial parties.

The trades

In bringing this claim, the Libyan Investment Authority (LIA) sought to unwind nine trades worth around US$1.2bn which it had entered with Goldman Sachs during 2008. The trades were synthetic leveraged derivative trades whereby LIA paid Goldman Sachs premiums in exchange for exposure to shares in underlying companies. Leverage enabled LIA to gain exposure to significantly more shares than could have been bought with the premiums. No shares were acquired in the transactions, but if the underlying share prices rose by the maturity date, Goldman Sachs would pay LIA the difference in value, multiplied by the total notional number of shares. While LIA stood to make a windfall if the share prices rose, Goldman Sachs would keep the premiums if they were the same or lower at maturity, leaving LIA with neither shares nor money.

Surrounding events

When the relationship between LIA and Goldman Sachs began in 2006, there was an air of optimism based on a belief that shares were significantly undervalued due to the then emerging financial crisis. Over the following months, an individual at Goldman Sachs called Mr Kabbaj worked hard to develop a close relationship with key individuals at LIA.

In early 2008, Mr Kabbaj held various meetings with LIA to finalise the first of the disputed trades: a US$200m investment in two trades with Citigroup as the underlying entity. Interestingly, LIA's CEO subsequently sought confirmation that LIA had not obtained any legal or beneficial interests in Citigroup shares. Goldman Sachs confirmed that was the case. This was followed by three further trades worth around US$175m with EDF as the underlying entity. Again, LIA requested and Goldman Sachs provided confirmation that LIA had not obtained any legal or beneficial interest in the underlying shares. A further four trades were concluded in April 2008, for which the total premiums payable amounted to US$825m.

Over the same period, Mr Kabbaj continued to invest his energies to enhance the relationship between Goldman Sachs and LIA. The court heard that Mr Kabbaj arranged a number of overseas trips and other forms of entertainment for members of LIA, including a training programme in London for junior members, which incorporated a lavish trip to Morocco with entertainment which was revealed to be "in flagrant breach of Goldman Sachs' policy on entertaining clients". Mr Kabbaj also arranged for the younger brother of LIA's deputy CEO to be given bespoke training at Goldman Sachs' London office which in fact became an eleven month paid internship.

It was not until mid-2008 that it became apparent that LIA had fundamentally misunderstood the nature of the trades: instead of agreeing to risk the loss of the premiums, LIA claimed that it thought that it had bought shares in the underlying entities with the help of a loan from Goldman Sachs. In light of this, various attempts were made to restructure the trades, but without success. Therefore, with the underlying share prices significantly lower on maturity than upon signing, each trade expired in 2011 worthless. LIA subsequently brought proceedings against Goldman Sachs alleging undue influence and seeking to set the trades aside as unconscionable bargains.

The principles of undue influence

In the absence of fraud or duress, the law will generally not intervene to save people from making improvident bargains. However, the equitable doctrine of undue influence seeks to ensure that parties can rescind contracts made as a result of the improper exercise of influence by one party over another. The leading authority is *Royal Bank of Scotland v Etridge (No 2)* [2001] UKHL 44, [2001] 2 All ER (Comm) 1061.

Claims fall into one of two categories: "actual" and "presumed" undue influence, but the key requirement in all cases is as summarised by the Court of Appeal in *Drew v Daniel* [2005] EWCA Civ 507, [2005] All ER (D) 84 (May): "The critical question is whether or not the persuasion or the advice, in other words the influence, has invaded the free volition of the donor to accept or reject the persuasion or advice or withstand the influence. The donor may be led but she must not be driven and her will must be the offspring of her own volition, not a record of someone else's."

Actual undue influence

There are two forms of actual undue influence. The first is where an improper threat or inducement is made. No prior relationship between the parties is necessary, but a specific instance of actual undue influence must be alleged. LIA alleged that Goldman Sachs improperly induced and therefore unduly influenced the deputy CEO to enter into the four April 2008 trades by offering his brother the internship in London and by providing him with extensive and lavish corporate hospitality.

The second form is where a protected relationship arises. In situations where one party is significantly more powerful than the other, the dominant party may acquire a duty to act with candour and fairness toward the weaker party. Transactions may be set aside where parties acquire and breach such duties. In *Etridge*, Lord Nicholls said that a protected relationship "arises out of a relationship between two persons where one has acquired over another a measure of influence, or ascendancy, of which the ascendant person then takes unfair advantage. The relationship between two individuals may be such that, without more, one of them is disposed to agree a course of action proposed by the other. Typically this occurs when one person places trust in another to look after his affairs and interests, and the latter betrays this trust by preferring his own interests. He abuses the influence he has acquired". LIA claimed a protected relationship had arisen before the Citigroup and EDF trades were concluded, and certainly by the time of the April 2008 trades. Furthermore, it alleged that Goldman Sachs ought to have suspected that LIA did not understand the true nature of the trades and therefore breached the duty of candour and fairness by proceeding with them. Such a breach, if proven, would have allowed the transactions to be set aside.

Presumed undue influence

In *Etridge*, Lord Nicholls explained that where a protected relationship arises and the weaker party identifies a questionable transaction, a rebuttable evidential presumption that the dominant party has unduly influenced the weaker will apply. Such a presumption reverses the burden of proof: the dominant party must prove that it did not unduly influence the weaker party. Having already alleged a protected relationship, LIA sought to question the nature of the disputed trades and burden Goldman Sachs with disproving the exercise of undue influence.

The findings

In reaching her judgment, Mrs Justice Rose applied these tests to a detailed analysis of the facts in the following ways:

Was the internship an improper inducement to enter into further trades?

LIA alleged impropriety as the internship was not offered because of the intern's potential merits as an investment banker; but Goldman Sachs argued that its motivation was to ensure that he would come to them for business if LIA went ahead with a plan for him to head up a new London office. The judge found that the internship could not be said to have amounted to an improper inducement nor undue influence; it was simply too remote from LIA's investment decision-making process.

> *"A transacting party would be well advised to ensure that it fully understands the nature of its relationship with its counterparty"*

Had a protected relationship arisen between the parties?

LIA's witness statements went to great lengths to show that it had no experience of running a sovereign wealth fund nor dealing in complex instruments and that it was reliant on Goldman Sachs to "hold their hands". However, the judge found that the CEO and deputy-CEO's lack of sophistication had been greatly exaggerated. It was impossible for her to accept that they could be so experienced in banking and finance without understanding the very basic distinction between a bank acting as a buying or selling counterparty and as an adviser or fiduciary.

As to LIA's claim that Goldman Sachs had promised a unique relationship with them, it was held that LIA placed too much weight on what amounted to sales pitches and failed to note that Goldman Sachs treated other counterparties across the Middle East in exactly the same way. Further, Goldman Sachs was not alone in marketing heavily to LIA—it emerged that at least 20 other banks paid for training and hospitality for LIA during the relevant period. There were additional factors that militated against a protected relationship: LIA's heavy reliance on international financial consultants; the numerous Goldman Sachs deals that LIA rejected and the transactions that LIA entered into with other investment banks. Taking these factors into account, the judge found that no protected relationship had arisen.

Did one or more of the transactions call for an explanation?

Given her other findings, the judge did not need to consider this question, but did so for completeness. While LIA argued that the trades were questionable because Goldman Sachs made very large risk-free profits from the premiums paid by LIA, Goldman Sachs claimed that there was nothing unusual in light of LIA's appetite for risk and that its target rates of return could only be realistically met through speculation. Mrs Justice Rose agreed with Goldman Sachs, finding that it had invested a great deal of time and money in placing the trades with LIA and that it was naïve to assume that such costs would not be reflected in the pricing of the trades.

Lessons learned

The judgment demonstrates a clear win for Goldman Sachs on all grounds: there was found to be no actual undue influence, no protected relationship, no questionable transaction, no presumed undue influence and as a consequence, no unconscionable bargain. LIA, which has sought permission to appeal, has since been ordered to make an interim payment to Goldman Sachs of £8.5m on account of estimated costs of £17.5m.

This case reminds us that, in circumstances where commercial parties transact with each other, the courts remain reluctant to intervene, even in circumstances where, on the face of the transaction, one of the parties is disadvantaged. Commercial parties are expected to negotiate their own terms without regard to the other side's interests. While the law of undue influence and unconscionable bargain exists to protect a party on whom there has been an improper degree of influence, the bar for establishing such claims remains high.

Furthermore, as demonstrated by the rather extreme facts of this case, a transacting party would be well advised to ensure that it fully understands the nature of its relationship with its counterparty, in particular the extent to which that relationship amounts to one of a fiduciary or adviser, or at all. **NLJ**

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