The liability of financial regulators for bank failures

by Charles Proctor

The Bank of England is currently being sued for allegedly failing in its supervisory role by the liquidators of BCCI on behalf of some 6,500 UK-based depositors who lost money when the bank collapsed and was shut down in 1991. The author reviews the basis in the UK and other jurisdictions for possible legal actions against financial regulators.

SUPERVISORY RESPONSIBILITIES

Purpose of the supervisory function

The objectives of prudential supervision in the United Kingdom include (i) the fostering of confidence in the financial markets in the United Kingdom, (ii) the promotion of public awareness of the risks and benefits involved in investment and financial dealings, (iii) the protection of consumers of financial services and (iv) the reduction of financial crime – see sections 2–6, Financial Services and Markets Act 2000. If the Financial Services Authority fails in meeting any of these very general requirements, can it be made liable in damages to disappointed depositors or investors?

Liability on tortious basis

On general principles, the regulator could *in theory* incur tortious liability in negligence to a depositor/investor who suffers loss as a result of placing funds with a supervised entity. The claimant would however have to establish that there exists (i) a duty of care owed by the regulator to a specific person or class of persons (including the claimant), (ii) a breach of that duty and (iii) actual loss suffered by the claimant as a result of that breach of duty.

Alternatively, the claimant might seek to establish the tort of breach of statutory duty. He would have to demonstrate that (i) there was a statutory duty to supervise the institution, (ii) the duty was imposed for the benefit of an identifiable class of persons, (iii) the claimant is a member of that class and (iv) there has been a breach of the duty.

Defences for the regulator

The courts recognise the governmental character of the supervisory process, that regulators have to balance competing interests (*eg* in deciding whether to revoke a licence) and that they should be able to perform their functions without undue fear of legal proceedings. As a result, the courts have held that depositors/investors cannot sue the regulator for losses resulting from a breach of statutory duty – *Davis v Radcliffe* [1990] 1 WLR 821 (PC). Likewise, depositors/investors cannot sue the regulator for losses flowing from the negligent licensing or supervision of a regulated entity, or the failure to withdraw a licence at an appropriate time – *Yuen Kun-Yeu v Attorney General of Hong Kong* [1988] AC 175 (PC).

The mere fact that a public authority acts beyond the scope of its powers does not of itself create a liability in tort/damages. There must be a statutory duty of care imposed for the benefit of a specific and limited group of people which includes the claimant – *X(Minors) v Bedfordshire County Council* [1995] 2 AC 633. The regulator usually benefits from statutory protections or immunities – *eg* the FSA is immune from actions arising out of the performance of their official functions, unless they are shown to have acted in bad faith or certain Human Rights Act considerations apply – see Schedule 1, Financial Services and Markets Act 2000.

Furthermore, in some jurisdictions, it has been explicitly recognised that a regulator owes his duties *to the public as a whole*, and not to individual investors. In the absence of a specific and targeted duty of care, the regulator cannot be liable for the loss of deposits in this type of case – see above. It follows from the points noted above that a regulator will not generally incur legal liability to depositors/investors for "mere" negligence in carrying out its licensing/supervisory functions. The regulator does not owe a duty of care to individual depositors or investors; alternatively, it enjoys a statutory immunity from suit. But this does not completely exclude the possibility of a successful legal action.

Misfeasance in public office

It will be noted that the statutory immunity provisions are not absolute – they can be overridden if the regulator has acted in bad faith: The rationale for the tort of "misfeasance in public office" lies in the requirement that public officers must exercise their executive powers for the public good, and not for some ulterior or improper purpose, whether or not involving a personal benefit to the officer concerned: *Jones v Swansea City Council* [1990] 1 WLR 54. In a society based upon the rule of law, public officials cannot be exonerated from legal liability if they exercise their powers improperly or capriciously.

The claimant must prove that:

- The defendant is a public officer;
- The acts of which complaint is made must involve the exercise of a public or official power – Cornelius v Hackney London Borough Council, The Times, 27 August 2002;
- The regulator acted in bad faith – ie it knew that it was acting outside the scope of its powers in the knowledge that this was likely to cause damage to depositors/ investors. The courts have tested this principle in relation to a veterinary inspector – Northern Territory v Mengel (1995) 69 AJLR 527; in relation to a police force – Garrett v Attorney General [1997] 2 NZLR 332; and in relation to the discharge of judicial functions by judges – Rawlinson v Rice [1997] 2 NZLR 651 and Harvey v Derrick [1995] 1 NZLR 314;
- The regulator owes a duty of care to the depositor/investor (this will not usually pose much difficulty because any individual has a right not to be damaged/injured by a deliberate abuse or reckless of power by a public officer);
- There is a (factual) causal link between the regulator's alleged breach of duty and the loss suffered by the claimant; and
- The losses in respect of which the claim is made must not be too remote (ie the public officer knew that his actions would be likely to give rise to the losses in question).

It will be seen that these requirements are fairly stringent. Ultimately, this is a classic situation in which the law seeks to balance competing interests. On the one hand, public officers must be accountable for their actions. But on the other hand, public officers must be allowed to carry out the functions for which they have been appointed, and they must accordingly be protected from legal actions which lack merit. It thus becomes necessary to consider how the courts have managed this balancing exercise in the decided cases.

THE COURTS AND THE REGULATORS

Background and four leading cases

The foregoing section has considered the theoretical basis for possible legal actions against financial regulators. The present section considers the practical outcome of some of the main litigation which has occurred in this area (although the choice of cases is necessarily selective). It is proposed to consider four leading cases in this area, in chronological order.

Yuen Kun-Yeu v AG of Hong Kong (1988)

The Hong Kong Commissioner of Deposit–taking Companies granted to the American and Panama Finance Co Ltd, a licence to accept deposits under the Deposit-taking Companies Ordinance. The Ordinance was specifically made in order "…to regulate the taking of money on deposit and to make provision for the protection of persons who deposit money, and for the regulation of deposit-taking business for monetary policy purposes…."

The claimants deposited moneys with the company before its licence was revoked, and lost most of that money when it subsequently went into liquidation. They sued the Hong Kong regulator for their losses, on the basis that he knew (or, with reasonable care, would have known) that the company was speculating with the depositors' money and/or was acting fraudulently. The depositors' claim failed, on the basis that the Commissioner owed to them no specific duty of care in exercising his statutory powers. In deciding how to exercise those powers, the Commissioner had to take into account a number of factors, including the possibility of improving the financial position of the licensed entity and the need to maintain confidence in the financial markets. The Commissioner's duties were owed accordingly to the public at large – not to individual depositors.

The granting of a licence did not amount to an official "seal of approval" and thus could not form the basis of a claim by the depositors. The issue of the licence did not create a government-backed warranty to the effect that all deposit-taking companies were sound and creditworthy. The claim against the Commissioner was accordingly bound to fail, and was struck out.

Davis v Radcliffe (1990)

This case arose out of the collapse of Savings and Investment Bank Ltd in 1982. SIBL was licensed to accept deposits by the Treasurer and the Finance Board, Isle of Man. Disappointed depositors sued the regulators, on the basis that they owed a duty adequately to supervise the business of SIBL.

Once again, the court found that the functions of the regulator were to be exercised in the general public interest, and no separate or specific duty of care was owed to the depositors as a class. Furthermore, the depositors were seeking to render the regulator liable for losses flowing from the default of a third party. The court would generally be reluctant to impose such an extensive duty of care – especially where the regulator had only secondary control over the conduct of SIBL's business.

As a result, the depositors' claim had to fail, and it was struck out without a full hearing.

Hall v Bank of England (2000)

This was a slightly different type of case, in that the claimant was the controlling shareholder (rather than a depositor) in the licensed entity. Bradford Investments plc was established by four members of the Hall family. Bradford took deposits from the public and was licensed for that purpose by the Bank of England. The proceeds were used to invest in cheap housing in the North of England, which was then let to tenants.

The Bank of England subsequently became unhappy with the management of Bradford, and imposed various restrictions on its business. New managers (acceptable to the Bank of England) were appointed and they were required to dispose of unoccupied properties as soon as possible. The relationship between the Hall family and the new management deteriorated. The Halls claimed that the policy for disposal of properties was disastrous, and was causing substantial losses to the Halls as shareholders. The Halls thereupon sued the Bank of England, on the bases that (i) it could have intervened in the disposal process and (ii) its failure to do so amounted to misfeasance in public office.

The Court of Appeal noted that "misfeasance in public office" involved proof of a deliberate and dishonest decision by the Bank not to exercise its statutory powers. Since there was no evidence of dishonesty, the claim was again struck out without a full hearing on the merits.

Three Rivers District Council v Bank of England (2000/2001)

These proceedings were instituted by depositors in BCCI, and the general background to the collapse of that institution is well known. Part of the depositors' claim rested on the alleged failure of the United Kingdom properly to transpose into domestic law the provisions of the (EC) First Banking Directive, and the Community requirement for a remedy in such case. This was an attractive approach for the depositors for it would relieve them of the barriers erected by the "bad faith" requirement. The House of Lords rejected this argument and (on the basis that the matter was "acte clair") refused to refer the question to the European Court of Justice.

It is believed that the House of Lords conclusion on the substantive point is probably correct, but the refusal to make a reference is perhaps unfortunate because: (a) the German Supreme Court has recently decided to refer precisely the same questions; and (b) the point is perhaps less clear than the House of Lords has suggested – see, for example, Andenas and Fairgrieve, *Misfeasance in Public Office, Governmental Liability and European Influences,* ICLQ October 2002, 757.

Liability for failure to implement the First Banking Directive could arise if (i) the result prescribed by the Directive entails the grant of rights to individuals, (ii) it is possible to identify the content of those rights on the basis of the Directive and (iii) there is a causal link between the failure to implement the Directive and the Loss suffered by the claimants: *Francovich v Italy* [1993] 2 CMLR 66. The first and second conditions to State liability were not met in this case. The First Banking Directive was merely a "first step" towards the mutual recognition of authorisations of credit institutions; full recognition was only achieved under the Second Banking Directive: *Parodi* case [1997] ECR I-3899.

Furthermore, the First Banking Directive referred to the protection of consumers, but only in a general way. It did not provide standards of supervision or provide benchmarks against which the conduct of the regulator could be judged. A general desire that consumers should be protected falls short of any sufficient indication of the rights to be conferred upon them. For these reasons, it is suggested that the House of Lords decision was correct on this point, although a reference to the European Court might have been desirable. It should be added that the conclusion of the House of Lords in this area in no sense prevents the EC Commission from taking proceedings against the United Kingdom if it believes that the Directive has not been implemented adequately in the UK. The Commission is in the process of instituting proceedings against the UK in relation to its implementation of the Insurance Directives and its supervision of Lloyds – see "Ministers face EU Action over Lloyds", (*Times*, 20 January 2003).

Having disposed of the issues based upon the First Banking Directive, it was necessary to consider whether the depositor's claim could proceed on other grounds. The depositors could not sue the Bank of England in "mere" negligence, because it enjoys the statutory protection contained in section 1(4), Banking Act 1987 – it could incur no liability unless bad faith could be proved. Consequently, they had to rely on the tort of "misfeasance in public office", the ingredients of which have been noted earlier.

It might be thought that the BCCI litigation was in many respects similar to the Hong Kong/Isle of Man litigation noted above. And yet – in sharp contrast to the earlier cases – the House of Lords (admittedly only by a 3-2 majority) allowed the claim to proceed to a full trial. Why was this the case? Although the decision is complex, it is suggested that it is motivated by three, key factors.

First of all, it was argued that the Bank of England acted unlawfully in granting a licence to BCCI in the first instance. In particular, it relied on the assessment of BCCI by the Luxembourg regulator. The Bank of England was entitled to do this provided that (i) it was satisfied with the nature and scope of the Luxembourg regulatory system and (ii) BCCI's principal place of business was in Luxembourg – section 9(3), Banking Act 1987. The difficulty was that BCCI was *incorporated* in Luxembourg but its *principal place of business* appears to have been in the United Kingdom. If that is so, then the Bank of England was not entitled to rely upon the Luxembourg assessment in issuing the licence. This is not of itself sufficient to enable the depositors to win their case – they would still have to prove bad faith and other elements of the misfeasance tort – but this factor nevertheless distinguishes the BCCI litigation from the previous cases.

Secondly, the Bank of England did not revoke the BCCI licence in 1990/1 even though (according to the depositors) it was by that time clear that BCCI was managed fraudulently and was insolvent. The Bank of England maintains that a rescue operation remained possible during this period, and that it was justified in allowing BCCI to continue business until it became clear that the rescue could not materialise. Again, this particular feature distinguishes the BCCI litigation from previous cases.

Thirdly, the House of Lords expressed concerns about the use which had been made of the Bingham Report. Whilst this had been prepared in a thorough and detailed manner, it was not intended for use in proceedings of this kind and its conclusions had obviously been reached without submissions on the part of the depositors.

The BCCI case has continued to the inspection of documents stage. It has been alleged that internal memoranda discuss the use of BCCI as a conduit for the money laundering activities of the then Panamanian President, Manuel Noriega. The depositors now allege that the regulators refrained from closing down BCCI on the grounds that this would upset Gulf rulers with interests in the bank, and that BCCI was allowed to continue trading for a period of three years after this information came to light – see the report in the Sunday Times, 25 August, 2002. Similar allegations were considered in the Bingham Report itself.

It is difficult to comment in further detail, given that the trial of the substantive issues has only just begun. Nevertheless, a few general points may be noted:

- The fact that BCCI may have been engaged in money laundering does not necessarily lead to the conclusion that it should have been closed immediately;
- Although the point is not entirely beyond argument, a failure to exercise a discretion to act will not normally amount to "misfeasance" on the part of the regulator; and
- Even if depositors can establish a misfeasance claim and show that the Bank of England should have revoked BCCI's licence at an earlier stage, their damages would have to be calculated to represent the difference between (i) the amount which the depositors would have recovered if the regulator had acted at the appropriate time and (ii) the amount which they actually recovered in the liquidation. This will involve some very difficult factual and accounting evidence.

Overview of the cases

What lessons can be drawn from these decisions? Whilst the BCCI case has inevitably caused some concern in regulatory circles, it is to be regarded as exceptional. In most other cases, the regulator has succeeded in striking out the claim, without detailed examination of the merits.

In general terms, it is suggested that the courts will continue to strike out claims of this nature. The BCCI litigation is unlikely to form a model for future judicial decisions in this area.

OTHER JURISDICTIONS

United States

The government of the United States and its agencies are generally immune from the jurisdiction of the domestic courts, save where such sovereignty has been explicitly waived (*Hercules Inc v United States*) 516 US 417, 1996. Such an express waiver has been given in relation to actions in tort – Federal Tort Claims Act.

But there is one exemption from the waiver which is important in the present context – the so called "discretionary function" exemption. The result is that the Government is <u>not</u> liable in tort where (i) the relevant governmental action involved a genuine choice or discretionary element; and (ii) the decision was essentially a matter of policy. Decisions concerning the licensing of financial institutions would generally constitute discretionary functions, with the result that disappointed depositors would be unable to pursue the regulatory at law.Likewise, the Tucker Act (28 USC s1491 (a)) includes a waiver in respect of claims against the United States under any contract (express or implied).

This led to difficulties for the US Government in connection with the savings and loans industry. Healthier thrifts were persuaded to take over weaker ones, on the basis of a contractual assurance from a government agency that they could account for "qualifying supervisory goodwill". This was essential for, otherwise, the acquiring thrifts would have been rendered insolvent. The Government subsequently introduced legislation to reverse this accounting treatment. Since the introduction of the new rules was in breach of the contracts made with the thrifts, those institutions could thus recover damages against the Government (*United States v Winstar Corp* 518 US 839, 1996).

Canada

The Canadian Supreme Court has recently considered the extent of a regulator's liability for a failed institution (*Cooper v Hobart*, 2001, SCC 79). The claim in that case was phrased in "pure" negligence – no attempt was made to plead the "misfeasance in public office" tort. The court held that two tests had to be satisfied namely (i) a foreseeability test; and (ii) a proximity text.

As to the first test, it was plainly foreseeable that (in the event of negligent supervision) depositors might lose their money. However, the depositors were unable to satisfy the second, proximity test, because there was no "close and direct" relationship between the regulator and the depositors. The regulator's duties were owed to the public as a whole, with a view to providing a general framework for an orderly market. This was inconsistent with the existence of a separate, private law duty to the depositors.

There were other considerations which negated the existence of a duty of care. In particular, the regulator was invested with broad discretionary functions which involved the formulation of executive policy. The Government cannot be found negligent in this field because a court is not entitled to substitute its own decision on policy issues. Equally, the imposition of a duty of care would (so far as the regulator is concerned) involve an indeterminate liability to an indeterminate number of investors. Thus, even had a duty of care arisen, the court would have negated it on policy grounds.

The depositor's claim accordingly failed.

Other common law jurisdictions

Hong Kong

The decision in *Yuen Kun-Yeu v AG for Hong Kong* has already been noted. Although a Privy Council decision, the case originated in Hong Kong and the decision of the Hong Kong Court of Appeal was substantially affirmed. A second case was heard in Hong Kong in 1991, arising from the governmental decision to close down BCCI (HK). A depositor applied for judicial review of the decision to close down the bank. The main ground was that the government had previously rescued Hang Lung Bank and thus created a "legitimate expectation" that institutions would be rescued. This argument failed because the Financial Secretary had made it clear at that time that bank rescues would be on a "case by case" basis, and some institutions might be allowed to collapse.

Australia

Banking supervision is in the hands of the Australian Prudential Regulation Authority. Under the relevant legislation, no legal action can be taken against the regulator " …. in respect of anything done or omitted to be done in *good faith* and *without negligence* in connection with the exercise of powers or the performance of functions …" under the applicable legislation (section 70A of the Banking Act 1959, as amended);

It is not immediately clear how far this helps the regulator. If it has acted in good faith and without negligence, then it would not be liable in any event, regardless of the section. However, if the Australian courts follow the Canadian decision in *Cooper v Hobart* the point will not arise because the regulator will not be found to owe a duty of care to depositors. It should be noted that the liquidator of the HIH Group has started proceedings against APRA in respect of its supervision of HIH – Canberra Times, 18 November 2002.

New Zealand

Under Section 146 of the Reserve Bank of New Zealand Act, the regulator is entitled to immunity so long as it has acted " …. in good faith and without negligence …". Once again, and for the reasons given earlier, it is not obvious how this protects the regulator. The New Zealand courts have held that there may be policy reasons for negating any duty of care which a market regulator might otherwise owe to individual market participants *(Oceania Aviation Limited v Director of Civil Aviation* (February 2001)).

More directly relevant is the decision in a case involving the Securities Commission, which was charged with the supervision of newspaper advertisements relating to securities. The court rejected the notion that these *public* or statutory functions were capable of creating a *private* law duty of care. In addition, the relevant legislation contained an immunity for the regulator, provided that it had acted with reasonable care (*Fleming v Securities Commission* [1995] 2 NZLR 514).

France

A case decided in 1996 suggested that the Commission Bancaire could be liable for "mere" negligence (*faute simple*) in the supervision of a financial institution – see the *El Shikh* case (Cour administrative d'appel, Paris, 30 March 1999), which arose out of the BCCI collapse. A similar result had been reached in relation to the supervision of an insurance undertaking (Proceedings by *Groupe Dentressangle*, 13 July 1999).

However, in the *Kechichian* case (30 November 2001) the Conseil d'Etat decided that the regulator could only be made liable on the basis of serious negligence (*faute lourde*) in the context of the regulation of the financial sector. In that case, the Commission Bancaire had failed to insist on recapitalisation plans which had previously been agreed, and the Bank became insolvent. The regulator had been guilty of *faute lourde*, but fraud within the bank was the main causative factor. The regular's liability was therefore limited to 10 per cent of the losses.

INTERNATIONAL ISSUES

Key problems

The issue here is one of diverse customer bases and the number of jurisdictions involved. Depositors might seek recourse in other jurisdictions; for example, a depositor in another EC Member State might seek to sue the FSA before the courts of that Member State, on the basis that it was primarily responsible for the supervision of the insolvent institution concerned. The principle of "home state" (rather than "host state") supervision operates in a European Community context.

There are potential difficulties involved in defending a diversity of suits brought in different jurisdictions with different liability tests, including issues of jurisdiction and state immunity.

Jurisdiction

Under the Brussels and Lugano Conventions on jurisdiction and the enforcement of judgments in civil and commercial matters, courts sitting within the Convention countries may assume jurisdiction over proceedings involving "…civil and commercial matters…." An action against a public authority acting in the discharge of a public junction is not a "civil or commercial matter" for these purposes – *Netherlands State v Rüffer,* Case 814/79 [1980] ECR 3807. Consequently, courts within Convention States cannot claim jurisdiction over a central bank regulator by virtue of the Conventions.

But – subject to any constraints imposed by international law – a national court may determine the extent of its own jurisdiction in accordance with its own national laws. This point is particularly relevant in relation to courts operating outside the Brussels/Lugano Convention areas. For example, a court sitting in the USA might claim jurisdiction over torts allegedly committed by the regulator of a foreign institution, on the basis that US depositors had lost money and the tort thus had direct and identifiable consequences in the United States (the "effects" doctrine) – see, for example, *Calder v Jones* 465 US 783 (1984); *Panavision International v Toeppen* (US Ninth Circuit Court of Appeals, 17 April 1998).

If sued in a foreign court, a regulator would also be unable to claim the benefit of the domestic immunities available to it within its home state, because (i) immunities of this kind are of a procedural character and (ii) a foreign court will apply its own domestic procedural rules – thus ignoring the statutory immunity. This conflict of law principle is generally recognised in most countries – see, for example, *Des Brisay v Goldfield Corporation* 637 F2d 680 (1979), *FDIC v Petersen* 770 F2d 141 (1985) and *International Tin Council v Amalgamet Inc* 524 NYS 2d 971 (1988). The same general principle is encapsulated in Article 1(2)(h) of the Rome Convention on the Law Applicable to Contractual Obligations.

State Immunity – United Kingdom

It follows from the points made above that a financial market regulator must at all costs avoid becoming a defendant to proceedings in a court outside its home state. This attitude is motivated not merely by nationalistic sentiment; it is necessary to preserve the procedural immunities conferred upon the regulator by domestic law. The market regulator would therefore be compelled to seek refuge in another – and entirely separate – form of immunity.

State immunity is ultimately derived from considerations of international law – all States are equal and thus no state can subject another state to its jurisdiction; see for example *The Christina* [1938] AC 485; *Rahimtoola v Nizam of Hyderabad* [1958] AC 379. This general form of state immunity is now encapsulated in the domestic law of the United Kingdom – see section 1(1), State Immunity Act 1978. But the international recognition of the rule may be seen from an examination of corresponding laws in foreign states, including: (i) section 1604, Foreign Sovereign Immunities Act 1976 (USA); (ii) section 3(1), State Immunity Act 1985 (Canada); and (iii) section 9, Foreign Sovereign Immunities Act 1985 (Australia).

Generally speaking, state immunity can only be claimed by the foreign state concerned, its government and its Head of State. However, a separately incorporated entity (*eg* a central bank or foreign entity similar to the Financial Services Authority) is also entitled to immunity if:

- The actions which are the subject matter of the proceedings involve the exercise of sovereign authority; and
- The state itself would have been immune in corresponding circumstances.

A financial regulator would normally meet these criteria.

There are a number of exceptions or cases in which immunity will not apply, for example (i) in the case of contracts of a commercial or financial character (s 3, State Immunity Act 1978) and (ii) damage to tangible property, where the damage results from an act or omission in the United Kingdom (s 5, State Immunity Act 1978). A bank deposit is not tangible property – rather, it is a chose in action or property in an intangible form.

In essence, immunity is intended to cover acts of a sovereign or governmental nature but does not extend to acts of a commercial or private character (see the exceptions noted above). It seems clear that the statutory regulation of the national financial sector must be regarded as a governmental (rather than private) function, and it follows from the points noted above that a foreign regulator would be immune from proceedings in the United Kingdom in respect of losses resulting from a failed bank under its supervision.

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