COMPARING UNDISCLOSED BACK-TO-BACK TRANSACTIONS UNDER US AND ENGLISH LAW; REFLECTING ON THE INTERSECTION OF LEGAL RISK, BUSINESS JUDGMENT, AND ETHICS

Market participants at EBACE last week continued to discuss broker intermediated undisclosed back-to-back sale and purchase transactions of corporate aircraft. The discussion considered the practicality, legality, ethics, and wisdom of these transactions. Opinions diverged on the frequency of these transactions.

Theoretically, brokers who intermediate undisclosed back-to-back sale and purchase transactions have a greater risk profile under general principles of US contract and tort law than they do under general principles of English contract and tort law. US law takes a holistic approach to the analysis of the relationship between the parties to a contract, and, where fraud is found to have occurred, US law permits plaintiffs to sue for punitive damages in addition to actual damages and for rescission of the contract. English law will start, and may very well end, with the contractual relationship, thus precluding claims sounding in tort. The plaintiff may sue for either rescission of the contract or actual and, in some cases, consequential damages. English law does not recognize punitive damages. The legal analysis is insufficient by itself to determine whether to pursue a back-to-back transaction. A more complete, three-dimensional analysis also includes business judgment and consideration of ethics.

The scope of this article omits a discussion of unique features of each law, such as the lex situs issue under English law, as well as other bodies of law, such as criminal law, economic sanctions regimes and anti-money laundering regulations. The scope of this article also omits a discussion of the impact third parties may have on an undisclosed back-to-back transaction.

1. Hypothetical transaction

Assume a corporate aircraft broker forms an affiliate that enters into a back-to-back sale and purchase of a corporate aircraft where both the seller and the buyer are sophisticated parties, whether entities or ultra-high net worth individuals. Neither the buyer nor the seller is aware of the other, nor has either asked the broker to structure the transaction as a back-to-back. The broker adds none of its own funds to any funds flows. The broker discloses neither the existence of the back-to-back transactions to either the seller or the buyer nor the fact that the broker adds none of its own funds to the funds flows; yet, the broker does not lie or make any misleading statements about these issues, either. The buyer pays the purchase price it expected to pay, the seller receives the purchase price it expected to receive, and the broker retains the positive difference between these two amounts. The price paid by the buyer and the price received by the seller both sit within a band representing the fair market value for the aircraft. Yet, each of the buyer and seller would have sought to further maximize its economic position, had it known the transaction was a back-to-back. The broker does not take an additional commission from either the seller or the buyer. No financing supports the purchase of the aircraft.

2. Broker liability under US law

US law includes rules that should limit the analysis of a contractual relationship to the four corners of the page, yet it imposes a general duty of good faith and fair dealing on parties to contracts. US law can take a holistic approach to the analysis of the relationship between the parties. For example, US law may ask whether the parties to a transaction owe duties of disclosure to one another, considering the totality of the facts and circumstances of their relationship, irrespective of what their contract states.

One should expect that US law will (to a greater or lesser extent) pierce the formality of a transaction in its attempt to determine whether the facts underlying a transaction include wrongdoing. For example, during contract formation, the omission of information that the broker knows, or should have known, is, or might have been, material to one of the parties, creates an opening that that party can use to overcome the formality of the back-to-back contracts. Claims for fraud or misrepresentation could, therefore, be sustained against the broker and its affiliate.

The measure of damages could include all, or a part, of the: difference between the price the seller actually received and what it would have received had it known the transaction was a back-to-back; and the difference between the price the buyer actually paid and what it would have paid had it known the transaction was a back-to-back. This is because the broker's failure to disclose its role and compensation arguably deprived each party of a benefit that it could otherwise have obtained had that information been available to it. The broker may also find itself subject to claims sounding in fraud, such as theft, conversion, and unjust enrichment. On this basis, the broker's behavior also opens the broker and its affiliate up to a claim for punitive damages.

A broker has defenses available to it, including that the parties to the transaction were sophisticated and knew, or should have known, that the broker was taking a commission that was built into each party's pricing. This defense is tenuous, at best; US law generally takes a dim view of misleading behavior and the logic could be criticized: if the parties knew, or should have known, that the broker had built a commission into the back-to-back transaction, then the broker had no excuse not to disclose it.

3. Broker liability under English law

English law emphasizes the parties' freedom of contract and considers that contracts should be upheld to the greatest extent possible when the parties have freely negotiated their terms. Consequently, English law does not impose any generalized duty of good faith, and it generally analyzes contractual disputes in isolation on a case-by-case basis. Moreover, during contract formation, English law does not generally impose on a party a duty to disclose facts (including problems) even if that party knows, or should have known, the facts are important or material to its counterparty. There are a limited number of exceptions that impose such a duty, but they are either difficult to prove or are irrelevant to the hypothetical underlying this article.

As a consequence, the starting point of the English legal analysis would be the content of the back-to-back contracts. If the content addresses a particular issue, then that content generally controls the outcome of that issue. If the content is silent as to that issue, then the court will seek to maintain the integrity of the contract. Therefore, if the contracts omit representations and warranties addressing the back-to-back transaction, then English law will likely determine that no wrongdoing occurred. This is because the broker's affiliate bought and sold the aircraft pursuant to two separate agreements, where each of the broker's seller and buyer received the benefit it bargained for.

Claims for misrepresentation and fraud, including by omission, may survive, if the misrepresentation induced the claimant to enter into the contract. The test for inducement requires the claimant's reliance on the misrepresentation to have been reasonable when the claimant entered into the contract. If the reliance was not reasonable, then the claim for misrepresentation will fail.

The remedies for misrepresentation and fraud are either rescission of the contract or actual damages. Consequential damages may also be available where damages are awarded. English law does not recognize punitive damages.

To the extent the back-to-back contracts are determined to be legal, valid, and binding, then the contacts should operate to vitiate claims for other torts, as well, such as theft, conversion, and unjust enrichment.

4. The intersection of legal risk, business judgment, and ethics

Considered abstractly, the law is merely an allocation of rights, obligations, and liabilities. From this perspective, no one has an obligation to do more than the law requires. To the extent that ethical elements appear in the law, it is because a policy decision has been made to include them within it. One's behavior that exceeds those legal minimums results from a judgment that that behavior adds value somewhere and to someone.

One's failure to follow the law can certainly result in one's incurring liability. One's failure to act ethically may not result in legal liability, but it can result in reputational damage or rendering one less sympathetic during litigation. And, litigation is expensive and inherently unpredictable. In that respect, every transaction is unique, and the facts of the hypothetical described in this article are, admittedly, limited to those required to highlight distinctions among general principles of US and the English contract and tort law.

There may be legitimate reasons to complete an undisclosed back-to-back transaction, such as making a market that might otherwise not exist. Yet, one ought to be mindful that aggressive business practices, irrespective of whether one has followed the law, can increase the likelihood that one will be a party to a lawsuit. For example, even if the broker's affiliate holds title to the aircraft for no more than an instant, appearing in the chain of title exposes the broker's affiliate to liability associated with aircraft ownership. Further, and more broadly, the corporate veil of the broker's affiliate could be pierced to hold the broker and individuals affiliated with the broker liable for damages a party incurs as a consequence of the undisclosed back-to-back transaction.

As a broader policy consideration, market participants should recognize the intrinsic value of ethically and transparently forming and performing contracts. The benefits include preserving one's reputation, preserving the integrity of the corporate aircraft market, ensuring the corporate aircraft market works efficiently, reducing the risk that one becomes a party to a lawsuit (or, if one becomes entangled in a lawsuit, then that person can be viewed sympathetically), and not foreclosing one's rights to equitable remedies.

That is why one should proceed cautiously when inclined to pursue an undisclosed back-to-back transaction.

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