Neutral Citation Number: [2021] EWHC 2706 (Comm)

Case No: FL-2018-000003

IN THE HIGH COURT OF JUSTICE
QUEEN'S BENCH DIVISION
BUSINESS AND PROPERTY COURTS
OF ENGLAND AND WALES
COMMERCIAL COURT: FINANCIAL LIST

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 12/10/2021

Before :

MRS JUSTICE COCKERILL

- -

Between :

Deutsche Bank AG London	**Claimant**
- and -	
Comune di Busto Arsizio	**Defendant**

- -
- -

Sonia Tolaney QC and Rupert Allen (instructed by **Allen & Overy**) for the **Claimant**
Paul Downes QC and Kevin Pettican (instructed by **Pietro Gatto**) for the **Defendant**

Hearing dates: 12 July 2021 – 29 July 2021

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Approved Judgment

Mrs Justice Cockerill:

Introduction

1. This is a case concerning certain swaps entered into by the Defendant ("Busto"), a small Italian local authority, in mid 2007. Its contractual counterparty was the Claimant, the well-known international bank Deutsche Bank ("DB"). The swaps were governed by English Law.

2. At the time of contracting, the swaps, which included swapping fully variable rate obligations for those with a collar and floor, were anticipated to be beneficial to Busto (to the tune of over €7.3 million by today's date as regards the principal exchange element). But of course in 2008 the world changed. The swaps have not proved beneficial. In this case Busto says that it is not bound by them – in particular that it lacked capacity to enter into them.

3. The history of local authorities and swaps in the courts is now a fairly long one and punctuated by a number of judgments exploring the capacity of different sorts of local authorities in a variety of jurisdictions[1].

4. Here, in very broad terms, the issues before the Court concern the interplay between, on the one hand, a variety of legislative sources of Italian Law, including Articles of the Italian Constitution and Civil Code; and on the other hand, a recent decision of the Joint Civil Divisions of the Italian Court of Cassation/Supreme Court – decision 8770/20 *Banca Nazionale Del Lavoro S.p.A v Municipality of Cattolica* ("*Cattolica*").

5. Busto says that the result is that as a matter of Italian law (as it is now to be understood post *Cattolica*):

   i) Principles of Italian administrative law (Article 119 of the Italian Constitution and mandatory rules of Italian public finance) limit the powers of Busto as an Italian local public body, so that Busto lacked the capacity to enter the swap transactions with the consequence that they are void; and/or

   ii) To the extent that it was within the legal power of Busto to enter the swap transactions at all, Busto could only do so if the swap transactions were approved by Busto's City Council (pursuant to Article 42(2)(i) of the Consolidated Code of Local Bodies). Since the City Council did not approve the swap transactions, they are void.

6. DB disputes these propositions. In very broad terms it says that *Cattolica* does not offer as much of a legal road block as Busto would argue; and that even if it does, on the facts of this case there is no basis for finding that capacity was lacking or that the relevant rules for approvals were not complied with. It seeks a declaration that Busto is bound by the terms of the swap transactions.

7. There are also numerous additional points and fallback positions on both sides.

[1] See for example *"Thirty Years of Ultra Vires: Local Authorities, National Courts and the Global Derivatives Markets"* by Braithwaite Current Legal Problems 2018 71(1) 369

8. In addition to its defence to the Bank's claim, Busto has a counterclaim for restitution of the net sums paid by Busto to the Bank. As of 30th June 2020, the stream of payments between the parties had produced a negative balance for Busto of €3,840,166.74 and €99,136.88 in respect of the two swaps.

9. If the swap transactions are void and unenforceable, the Bank claims that Busto's restitution counterclaim is governed by English law and raises defences of limitation and change of position. Busto's position is that its restitution counterclaim is governed by Italian law, but even under English law the Bank's defences have no merit.

10. If the swap transactions are void, the Bank raises a fallback case based on Article 1338 of the Italian Civil Code. Busto's position is that there is no merit in the Bank's claim under Article 1338 as: (i) Busto did not know and could not reasonably have been expected to know of the nullity of the swap transactions at the time that they were entered into in 2007; and (ii) in any event, the Bank cannot establish that it relied without fault on the validity of the swap transactions in circumstances where the Bank was in a far better position than Busto to know the swaps were void.

11. Because of the range of issues involved this judgment is divided into three parts (Background, Determinative Issues and Contingent Issues) and the following sections:

i) Introduction

ii) Part 1: Background

a) Factual Background [12]

i) DB's involvement [26];

ii) The City Board Resolution [41];

iii) Final Steps [46];

iv) The relevant terms of the Transactions [52];

v) The structure and financial essentials of the deal [56];

vi) Subsequent events [73].

b) Legal background:

i) Swaps in the Courts of England and Wales [84];

ii) The Approach to Foreign Law [104];

iii) The relevant Legislative Provisions [109];

iv) The *Cattolica* Decision [120];

(a) First Instance: Case No. 5244/2009: The Court of Bologna [125];

(b) On Appeal to the Court of Appeal of Bologna: Case No. 734/2014 [127];

(c) The Supreme Court [131]

c) The trial [156];

d) The issues [170].

iii) Part 2: The Determinative Issues

a) Capacity absent *Cattolica* [173];

b) Capacity and Section 9 of *Cattolica* [206];

c) *Cattolica* and Speculation [275];

d) Ministerial Decree 389 and Law 448/2001 [307];

e) Article 42 of TUEL [317];

f) Determination and matters for consequential argument [365].

iv) Part 3: Contingent Issues

a) The other TUEL issues [367];

b) The restitution claim [410];

c) Article 1338 [419]

Part 1: Background

Factual Background

12. DB is incorporated in Germany with a branch in London. It is part of the Deutsche Bank Group of companies. In 2007, at the time of the events giving rise to this dispute, the Bank operated in Italy through an Italian subsidiary of the Deutsche Bank Group, namely Deutsche Bank S.p.A. DB has operated in the Italian local authorities' market since 1980.

13. Busto is the local municipal authority for the city of Busto Arsizio in part of the Province of Varese in Lombardy, Northern Italy. It is a small city with approximately 83,000 residents.

14. Mr Downes QC for Busto has repeatedly emphasised that this is a case about a small local authority acting for a small number of real people and that the sums in issue here are very meaningful to them. He pointed out that in 2007 Busto had revenues of €47,293,616, of which €30,551,749 represented tax revenue collected from its local citizens, and €16,741,867 represented transfers from the Italian State. In 2007, Busto's total expenditure on social and educational services for the year was €12,404,123.

15. In 2007, Busto had outstanding borrowing from various lenders which amounted to €72.8 million, 57% of which was at a variable interest rate. The final repayment date on these loans was on 30 June 2031, however the repayments were structured such that the principal amounts due were heavily concentrated between 2007 and 2014. In particular, as at 2007 Busto's repayment profile required 52% of its outstanding borrowing to be paid over the next 6 years up to the end of 2013, whilst repayment of the remaining 48% would be spread out over the next 18 years.

16. Busto had previously entered into an interest rate swap with Banca Monte dei Paschi di Siena ("MPS") in 2002 ("the 2002 Swap"), under which Busto would pay a variable interest rate to MPS whilst receiving a fixed interest rate in return (the relevant terms are set out in more detail below at paragraph 56). While there was some suggestion in passing that there might be a question over the validity of this swap, that formed no part of the pleaded case, and I assume that swap was valid.

The City Council and City Board

17. This case raises some issues about the government structure in relation to Italian local authorities. In particular there is an issue about whether approval of the relevant swaps fell to the City Council or the City Board.

18. Busto's City Council is the democratically elected body of the municipality. In 2007 it had 30 members. Broadly speaking, it was common ground that the role of the City Council within the municipal administration is to set overarching policy and guidelines. It is then for the City Board and the administrative departments to implement that policy. The role of the City Council is to make policy and set guidelines, and would not generally extend to the entry into contracts. It was the evidence of Prof. della Cananea that the separation of responsibility for policymaking, on the one hand, and policy implementation and managerial activity, on the other, was a fundamental distinction in Italian administrative law.

19. The City Board is the executive political body and it is therefore entitled to exercise political discretion in its own right. It is not democratically elected but is made up of up to twelve individuals appointed by the Mayor (who also chairs the Board). The Mayor is democratically elected in direct elections. Busto also has various administrative departments, each with a Director at its head.

20. As set out in Busto's Municipal Bye-Laws, the City Council has the decision-making powers that are provided by Article 42 of Legislative Decree No. 267 of 2000 (also referred to as "the Consolidated Code of Local Bodies"). Those provide that:

    i) The City Council is responsible for all matters bearing on the financial position of the authority. For example, Article 42(2)(b) is concerned with the budgets (and changes to the budgets); Article 42(2)(f) is concerned with the introduction of taxes and regulations concerning taxes; Article 42(2)(h) concerns the taking out of loans, credit facilities and bond issuances; Article 42(2)(i) concerns expenditure which commits the budgets of the authority for subsequent financial years ; and Article 42(2)(j) is concerned with real estate purchases and disposals.

    ii) Both the City Council and the City Board are responsible for *"political-administrative guidance"* (Article 8(1) and Article 14(1)).

iii) The City Board is also responsible for:

a) *"the collective implementation of the City Council guidelines"*;

b) for issuing its own guidelines "*specifying the City Council guidance"* (Article 14(1)-(2));

c) *"all acts pursuant to Article 107, paragraphs 1 and 2, in the functions of government bodies, which are not reserved by law to the city council"* (Article 48(2)).

The problem

21. On 2nd April 2007, the City Council passed resolution no. 32/2007 ("the City Council Resolution"), by which it approved Busto's budget for 2007, its multi-annual budget for 2007-2009 and also the Forecast and Planning Report for 2007-2009.

22. That Report identified a cashflow problem being faced by Busto at that time:

> "For many years the Municipality of Busto Arsizio was able to substantially maintain fiscal pressure unchanged, but in the meantime, the gap between income and expenses has widened considerably, also because of lower transfers from the State. Therefore, on the one hand, income continued to increase at an 'unchanged' rate, while on the other, the cost of staff and utilities, in addition to the increase given by the rate of inflation, resulted in a significant increase in current expenses of more than EUR 4,000,000.00"

23. That passage went on to set out four measures which were *"set for 2007"* in order to solve the problem. One such measure was for *"use of financial instruments that are useful for debt restructuring through a swap on interest and principal."*

24. The Report went on to discuss possible methods of debt restructuring, including:

> "the application of the derivative instruments (swaps) covered by the Decree of the Minister of Economy and Finance No. 389/03, under which debt may be managed through the application of derivative instruments to change the structure of interest rates."

25. After further discussion of such swaps, the Report goes on to state that:

> "It is considered appropriate to use the above strategies to achieve the maximum economic and financial benefits, but especially with regard to renegotiation and derivative transactions, one should seek the support of a financial advisor who, free of charge, will assist the Administration in the implementation of these strategies."

DB's involvement

26. In 2007, the Director of Busto's Finance and Economics Department was Mr Massimo Fogliani. He held that post until 2009 when he was succeeded by Ms Marino (one of the factual witnesses called in this case).

27. On 13 April 2007, DB delivered a presentation to Busto entitled, *"Debt management in Italian public authorities: The Deutsche Bank approach"* ("the First Presentation"). This appears from the slides to have been an introductory presentation in which DB, *inter alia*, set out its expertise (Busto emphasised that DB spoke of its *"incomparable experience"*) in dealing with Italian public authorities before going on to discuss, in general terms, some of the options which were likely to be available to Busto for the management of its debt. The presentation included a few slides on the "*basic legislation*" which Italian local authorities were required to comply with at the time.

28. On 24 April 2007, Mr Vizzini of the Bank sent an email to Mr Fogliani attaching a draft of an agreement which was to become a Mandate ("the Mandate"). On 8 May 2007, Busto's City Board resolved to confer on the Bank on a non-exclusive basis the role of advisor *"for the active management of the Municipality's debt (including all services related to the possible issuance of bonds and to the possible completion of any other financial transactions, including derivatives, that the Municipality might deem useful…)"*, and to approve the terms of the Mandate.

29. On 29 May 2007, Busto and the Bank entered the Mandate, pursuant to which Busto engaged the Bank, on a non-exclusive basis, to advise Busto on the matters set out in the Mandate. The Mandate is governed by Italian law and provides that the Courts of Milan shall have exclusive jurisdiction to settle any disputes arising from the Mandate. It states that DB was appointed as Busto's advisor *"for the preparation and setting of transactions of active management of the debt"* including, *inter alia*, derivative transactions. No fee was payable to DB in respect of this agreement.

30. On 31 May 2007, DB delivered another presentation to Busto entitled, *"Analysis of the municipal indebtedness and cash flow swap proposal"* ("the Second Presentation"). This presentation included a detailed analysis of Busto's outstanding borrowing and its debt repayment profile. The presentation then set out DB's proposals for a cash flow swap (to rebalance the profile of Busto's principal repayments which, as noted above, were heavily concentrated in the period 2007 to 2014) ("the Cash Flow Swap") and a mirror swap (to cancel out Busto's exposure to interest rate risk under the 2002 Swap) ("the Mirror Swap"). This structure was the basis of the transactions ("the Transactions") ultimately entered into.

31. The presentation further identified the benefits to Busto of DB's proposal, namely that it: (i) *"generates liquidity in the medium term thanks to lengthening of the average life of the debt"*; (ii) *"protects the Municipality from excessive interest rate volatility"*; and (iii) *"normalises the Municipality's total payment flows"*. In practical terms, the presentation indicated that this would be done by reducing the principal amounts due between 2007 and 2013 (which would be offset by increased principal repayment amounts thereafter) and by containing Busto's interest rates within a collar. An updated presentation which was materially similar was given by DB to Busto on 11 June 2007 ("the Third Presentation").

32. DB's regular legal advisers in respect of its derivative contracts with Italian local authorities were Allen & Overy ("A&O"). One of the witnesses called at trial was Mr Danusso of A&O, the partner in charge of the relevant A&O team. He explained in his evidence that after he joined A&O in 1998 he started acting for the Bank on a regular basis in respect of the Bank's entry into derivative contracts with Italian local authorities. The relationship between DB and A&O in Italy was sufficiently close that in 2007 A&O had seconded at least one of its Italian lawyers, Mr Alessandro Buono, to the Bank.

33. On 8 June 2007, Mr Buono emailed Mr Domenico Gaudiello (an associate at A&O) a draft resolution of Busto's City Board which would, *inter alia* (and if passed), authorise *"the use of derivative instruments applicable to financial transactions involving past indebtedness"* and give the director of the relevant department within Busto a mandate to *"identify the proposal that best meets the needs of the Municipality"*. Mr Gaudiello replied with an email which simply said *"Call me and I will tell you"*. The contents of any subsequent phone call which may have taken place are not known.

34. On 19 June 2007, Mr Fogliani invited DB and four other banks to submit formal debt restructuring proposals to Busto. In his formal decision no. 403/2007, Mr Fogliani stated that Busto:

> "in implementation of the directions contained in the General Development Plan for 2007 intends to acquire, without any charge or commitment whatsoever, a proposal for restructuring its indebtedness situation, in order to reduce budget charges for servicing the debt, maintaining a low risk profile."

35. DB submitted its proposal to Busto on the same day (19 June 2007). The proposal's objectives were identified as *"counteracting the effects generated by"* the 2002 Swap and rescheduling Busto's repayment plan such that *"the repayment instalments of the principal are distributed over time, freeing up resources over the next few years."* These objectives were to be achieved through a Mirror Swap and a Cash Flow Swap respectively.

36. DB's proposal for the Cash Flow Swap consisted of a principal exchange and an interest rate swap in respect of €55,041,117 of Busto's outstanding borrowing; of which €24,575,647 was at a fixed interest rate and €30,465,470 was at a variable interest rate. Under the principal exchange, Busto would be the net recipient of €13.1 million up to the end of 2013, whilst DB would be the net recipient of the same sum from 2014 through to 2031, such that the principal exchange amounts would net to zero. Under the interest rate swap, Busto would pay variable interest rates within a collar.

37. The proposal also stated that *"The new structure will also incorporate the value (negative or positive) of the mirror swap structure, evaluated at the date of its potential closure."* Further, it contained a section entitled *"Legal assistance to structure the financial transactions requested"*, which stated that:

> "For all the transactions described up to this point and for all issues of a purely legal nature connected to the performance of the role of adviser, Deutsche Bank shall make fully available to the Municipality of Busto Arsizio the services of **Allen &**

> **Overy**, a leading international law firm with offices in Rome and Milan, the undisputed market leaders in transactions involving Italian local authorities.
>
> Attorneys from Allen & Overy law firm shall participate, as required, in meetings between the Municipality and Deutsche Bank, to ensure full legal support for all the individual transactions considered by the local authority.
>
> We attach to this proposal, the introduction letter from Allen & Overy law firm, in which it demonstrates its willingness to assist Deutsche Bank in relation to possible capital market transactions for the Municipality of Busto Arsizio.
>
> Deutsche Bank shall bear all related costs."

38. On 22 June 2007, by executive decision no. 417/2007, Mr Fogliani appointed an expert committee to assist Busto in analysing and evaluating the various banks' proposals ("the Expert Committee"). The members of the Expert Committee included Mr Fogliani himself and Ms Marino, who was then the Head of the Accounting Service within Busto's Finance and Economics Department. The other members of the Expert Committee were Dr Sergio Zucchetti and Dr Simona Criscuolo of LIUC University in Castellanza.

39. On 25 June 2007, DB emailed Busto with a request for a letter to be signed on behalf of Busto stating as follows:

> "Please accept this letter as confirmation that Massimo Fogliani has authority to enter into a relationship and open accounts with Deutsche Bank AG, London on behalf of the Comune di Busto Arsizio."

40. A letter in those terms was signed by Mr Fogliani as "Authorised Signatory" and returned to DB on the same day.

The City Board Resolution

41. On 26 June 2007, a member of the DB sales team sent Mr Fogliani a draft resolution of Busto's City Board which would (if passed) approve the structure of DB's proposal and grant wide powers to Mr Fogliani to complete the transaction.

42. On 29 June and 5 July 2007, DB sent Busto simulations of the projected cost of the proposal based on potential future interest rates. The second of these documents showed the existing amortisation and interest side by side with the proposed amortisation and interest – at the cap rate and at the floor rate - with figures at every six months until expiry in 2031. The simulations also gave projections of the cost of the proposed revised principal repayment profile based on the forward curve, as well as on the basis of assumptions as to Euribor levels which reflected the collar structure of the Cash Flow Swap.

43. On 10 July 2007, in resolution no. 398/2007, the City Board formally approved the structure of the transactions proposed by DB and authorised Mr Fogliani to *"optimise the terms"* of the transactions. This resolution refers, inter alia, to the City Council Resolution, to *"the Provisional and Planning Report 2007-2009"* approved thereunder and to *"the implementation"* of *"the instructions"* thereby given by the City Council *"to verify the possibilities offered by the markets for restructuring of debts by way of derivative instrument transactions and specifically the need to intervene on the debt stock through definition of a swap"*. In light of a report by the Expert Committee, the City Board's resolution also confirmed that DB's proposal offered *"the greatest financial benefit over the next three-year period"*.

44. That report of the Expert Committee set out its conclusions in respect of the DB proposal as follows:

> "[T]he proposal which involves a higher capital and has a greater financial benefit over the next three years is undoubtedly the Deutsche Bank proposal.
>
> This proposal allows an overall financial benefit over the next 7 years (2007-2013) amounting to EUR 13,100,000.00 on the capital. From 2014 through 2031, the Municipality must provide for increased capital allowances of the same total amount.
>
> The effects of this transaction must be underlined.
>
> In the first few years and in particular up to 2013, the municipality will be able to book as part of its capital revenues the positive value amounts described in Annex A to these minutes (under the item expected differentials). The municipality will therefore be able to use this revenue to finance works on capital account without having to take out new loans.
>
> On the other hand, from 2014 to 2031, it will have to finance with current revenues higher charges (for the repayment of capital) equal to the values shown in Annex A with a negative value.
>
> The more the Municipality will be able to effectively use the resources that will become available, the more it will benefit from the transaction.
>
> As regards interest rates, the new structure provides for a fixed rate of 4.45% in 2007 and a variable rate of 6-month Euribor plus a spread of 0.10% from 2008 to 2031, with a maximum limit of 5.75% and a minimum limit of 5.15%. From an interest structure standpoint, the proposal therefore provides for a limit of 5.75% which will ensure that the municipality improves its current risk position. It should be noted, however, that the floor (i.e. the minimum ceiling that the municipality will have to pay) appears rather high in relation to the forward curve […].

> Based on this curve, this value will never be reached and therefore the possibility of modifying the parameter (floor) should be checked with the institute."

45. On 11 July 2007, Busto wrote to DB to inform it that the City Board had approved DB's proposed structure and to request a lower floor level in the interest rate collar.

Final steps

46. On 12 July 2007, DB's Credit Risk Management Team approved the proposed swaps subject to, *inter alia*, *"ultra vires being completed before trading (i.e., legal opinion covering compliance with regulatory environment)"*.

47. A revised proposal was submitted to Busto by DB on 16 July 2007 which incorporated a lower floor rate. The revised proposal also provided for reduced exchange amounts under the principal swap, such that Busto would be the net recipient from DB of €11.8 million between 2007 and 2013 with the same amount repaid by Busto to DB between 2014 and 2031 (as opposed to €13.1 million under the original proposal).

48. On the same day, DB requested a fee estimate from A&O for a legal opinion regarding the proposed swaps. Ms Sara Cerrone of A&O, having discussed with Mr Danusso, quoted a fee of approximately €7,000 and further stated that:

> "For the purposes of such legal opinion, we would firstly need to receive the term sheet relating to the transaction and, as soon as available, the resolutions and decisions authorising the transaction (including extracts from the RPP or the PEG to verify the general guideline of the local authority) and the relevant contractual documentation."

49. DB's revised proposal was approved by Busto's City Board by resolution no. 417/2007 on 17 July 2007. This resolution also conferred authority on Mr Fogliani by *"granting him the widest powers, to carry out all the necessary and useful acts for the execution of the swap transaction"* on Busto's behalf, including, in particular:

> "a) the negotiation and signing of the legal and contractual documentation in English in use in the financial markets and consisting of the ISDA Master Agreement and related schedule, including the related annexes forming an integral part of the above mentioned documentation, as well as the contractual documentation indicating the economic and commercial conditions of the individual swap transaction referred to in the attached proposal (Term Sheet and subsequent Confirmation), with the right to make, where necessary, any changes and additions that may result from changes in the provisions of the law, as well as to agree on any other changes that may be useful and appropriate, in compliance with the conditions set out in this resolution, all on the basis of the attached documentation that is hereby approved;

> b) the signing and completion of everything else that is necessary or appropriate for the successful execution of the swap transaction described in this resolution and in the attached proposal."

50. On 18 July 2007, DB sent the final contractual documents to Busto. These consisted of the ISDA Master Agreement, its Schedule and the final term sheet for the Transactions. This includes at sub-paragraph (b):

> "This transaction has a positive mark-to-market for Deutsche Bank which, at the time the transaction is entered into, considers the negative mark to market of the "Interest Rate Swap - Mirror Trade" transaction."

51. Before they were executed, Mr Fogliani emailed the documents to the Italian Ministry of Economy and Finance, as he was obliged to do under Italian law. On the same day, Mr Fogliani then approved the signing of the documents by Executive Resolution No. 489/2007 and subsequently executed them.

The relevant terms of the Transactions

52. The ISDA Master Agreement, as amended by the Schedule, contains a number of representations. Section 3 (as amended) reads as follows:

> "Each party represents to the other (which representations will be deemed to be repeated by each party on each date on which a Transaction is entered into and at all times until termination of such a Transaction) and, for the purposes of Section 3(g), [Busto] represents to [DB] (which representations will be deemed to be repeated by it at all times until the termination of this Agreement) that: -
>
> (a) Basic Representations …
>
> (ii) **Powers**. It has the power to execute this Agreement and any other documentation relating to this Agreement to which it is a party, to deliver this Agreement and any other documentation relating to this Agreement that it is required by this Agreement to deliver and to perform its obligations under this Agreement and any obligations it has under any Credit Support Document to which it is a party and has taken all necessary action and made all necessary determinations and findings to authorise such execution, delivery and performance;"
>
> (iii) **No Violation or Conflict**. Such execution, delivery and performance do not violate or conflict with any law applicable to it, any provision of its constitutional documents, any order or judgment of any court or other agency of government applicable to it or any of its assets or any contractual restriction binding on or affecting it or any of its assets;…

(v) **Obligations Binding**. Its obligations under this Agreement and any Credit Support Document to which it is a party constitute its legal, valid and binding obligations, enforceable in accordance with their respective terms (subject to applicable bankruptcy, reorganisation, insolvency, moratorium or similar laws affecting creditors' rights generally and subject, as to enforceability, to equitable principles of general application (regardless of whether enforcement is sought in a proceeding in equity or at law)).…

(g) with respect to [Busto] only:

(1) **Non-Speculation**. This Agreement and the Transactions hereunder will be entered into for purposes of managing its borrowings or investments and not for purposes of speculation, pursuant to Article 3, paragraph 3, of Decree no. 389 of 1 December 2003 issued by the Treasury Department of the Ministry of Economy and Finance and the Ministry of Interior and published in the Official Gazette no. 28 of 4 February 2004 (the **"Decree"**);…

(4) **Status**. [Busto] has a specific expertise and experience in transactions having as an object financial investments and thereby it is a professional investor pursuant to Article 31 of the Regulation no. 11522 of 1 July 1998, issued by CONSOB ("Regolamento Intermediari").…

(6) **Decree**. (i) Each Transaction will be entered into in conformity with the Decree and (ii) in compliance with Article 3, paragraph 4, of the Decree, [Busto] shall gradually tend towards ensuring that the overall nominal amount of the transactions entered into between [DB] and [Busto] will not exceed 25% of the totality of the derivative transactions entered into by [Busto]…

(h) with respect to each party:

(i) **Non-Reliance**. It is acting for its own account, and it has made its own independent decisions to enter into that Transaction and as to whether that Transaction is appropriate or proper for it based upon its own judgement and upon advice from such advisers as it has deemed necessary. It is not relying on any communication (written or oral) of the other party as investment advice or as a recommendation to enter into that Transaction; it being understood that information and explanations related to the terms and conditions of a Transaction shall not be considered to be investment advice or a recommendation to enter into that Transaction. No communication (written or oral) received from the other party shall be deemed to be an assurance or guarantee as to the expected results of that Transaction.

> (ii) **Assessment and Understanding**. It is capable of assessing the merits of and understanding (on its own behalf or through independent professional advice), and understands and accepts the terms and conditions and risks of that Transaction. It is also capable of assuming, and assumes, the risks of that Transaction.
>
> (iii) **Status of Parties**. The other party is not acting as a fiduciary for or adviser to it in respect of that Transaction."

53. Additionally, Section 1(c) of the ISDA Master Agreement provides:

> "**Single Agreement**. All Transactions are entered into in reliance on the fact that this Master Agreement and all Confirmations form a single agreement between the parties (collectively referred to as this "Agreement"), and the parties would not otherwise enter into any Transactions."

54. The first Transaction entered into was the Mirror Swap. The terms of the Mirror Swap were contained in the following documents (collectively, the "Mirror Swap Transaction Documents" and, together with the Cash Flow Swap Transaction Documents, the "Transaction Documents"):

    i) The Master Agreement;

    ii) The Schedule; and

    iii) The Confirmation of the Mirror Swap, with the Claimant's reference 1984604M, dated as of 9 August 2007 (the "Mirror Swap Confirmation").

55. The second Transaction entered into was the Cash Flow Swap. The terms of the Cash Flow Swap were contained in the following documents (collectively, the "Cash Flow Swap Transaction Documents"):

    i) The Master Agreement;

    ii) The Schedule; and

    iii) The Confirmation of the Cash Flow Swap, with the Claimant's reference 1984503M, dated as of 31 July 2007 (the "Cash Flow Swap Confirmation").

The structure and financial essentials of the deal

56. It is common ground that the Mirror Swap was intended to reverse out the 2002 Swap for Busto. Under the 2002 Swap, Busto was required to pay MPS a variable interest rate against a reference amount of approximately €18.5 million reducing to €8m over the period 2002 to 31 December 2011. That variable rate was:

    i) If 6m Euribor fell below 5.5%: 6.21%;

    ii) Otherwise: 6m Euribor + 4.85%.

57. The terms of the Mirror Swap between DB and Busto were the inverse of the terms under the 2002 Swap. Accordingly, under the Mirror Swap, Busto would pay to DB a fixed rate of 6.5% against the remainder of the same reference amount (which stood at approximately €14 million in July 2007), whilst DB would pay Busto a variable rate on the same terms as Busto's variable rate under the 2002 Swap. The notional amount would still amortise at the end of 2011, and the Mirror Swap would thus come to an end at the same time. The various interest payments were to be made every six months under both the 2002 Swap and the Mirror Swap.

58. It is fairly apparent that the 2002 Swap was onerous, especially if Euribor were to rise above 5.5%. As noted, while it was suggested in passing that it was not valid, there was no pleaded case on this, as there would need to have been, since both sides would have had to have had the opportunity of calling evidence on this, in particular expert evidence.

59. As regards the Cash Flow Swap, the structure and financial essentials of the deal were encapsulated in a very clear note for closing by Mr Allen, with which no significant issue was taken by Busto. The section which follows draws heavily on that uncontentious note.

60. The Cash Flow Swap consists of two elements:

    i) Principal exchange; and

    ii) Interest rate swap.

61. DB's final proposal of 16 July 2007 was based on part of Busto's total outstanding borrowing. The underlying debt for DB's final proposal was in the amount of €55,041,118.62, owed to various lenders and amortising in 2031. Out of this total amount, Busto was paying variable interest rates against €30,465,471.15 and fixed interest rates against €24,575,647.47.

62. The average interest rate on the fixed rate borrowing underlying the Cash Flow Swap was 5.34%, although the majority of this fixed rate borrowing (€17,691,442) was from Cassa Depositi e Prestiti at a higher average fixed rate of 5.53%. However, the average spread to Euribor on Busto's variable rate borrowing was 0.115%.

63. At this time Busto's total outstanding indebtedness was c.€72.8m. Certain loans were excluded from the underlying debt of the initial proposal for the Cash Flow Swap. There is no clear evidence as to why these loans were excluded, although some of the debt so excluded was short-dated or in small amounts. The interest-free loans to Busto from the Lombardy Region (in the amount of c.€2.3m) were also excluded.

64. The Cash Flow Swap consisted of a principal exchange and an interest rate swap, the commercial terms of which were, in essence, as follows:

    i) The principal amount paid by DB to Busto corresponded to the principal repayment which Busto was obliged to pay on the underlying indebtedness. Busto agreed to pay DB a different principal amount which corresponded to the rebalanced principal repayment profile that had been agreed with DB.;

ii) DB would pay Busto *"interest accrued on the debt stock considered (variable & fixed)"* i.e. DB would pay the accrued interest on Busto's fixed and floating rate borrowing. Busto would swap this interest for an obligation to pay DB variable rate interest subject to a maximum cap and a minimum collar. The accrued interest on Busto's fixed rate borrowing was therefore included in DB's fixed payments. DB would thus pay Busto fixed amounts which started at €2,550,517.16 reducing over the 24 year term to €61,182.22;

iii) Thus, DB would pay a fixed interest rate of 5.34% against the notional €24.5 million portion of the underlying debt and a floating rate of Euribor plus 0.115% against the notional €30.5 million portion. Meanwhile, Busto would pay a floating rate of Euribor plus 0.35% against the total underlying notional amount of €55 million, subject to a cap of 5.95% and a floor of 4.97% (increasing to 5.2% from 2016 onwards);

iv) DB would pay Busto the principal sums due on the underlying debt until 2031; meanwhile, until the end of 2013, Busto would pay sums to DB which would be less than the sums due on the underlying debt, then from 2014 to 2031, Busto would pay DB sums which would be higher than the amounts due on the underlying debt;

v) As a result of these payments, Busto would be the net recipient of €11.8 million from DB between 2007 and 2013, whilst DB would be the net recipient of the same sum from Busto between 2014 and 2031, after which the total sums paid between the parties by way of principal exchange would net to zero;

vi) As with the Mirror Swap, the various payments under the Cash Flow Swap fell due every six months.

65. Additionally, the final term sheet stated that the Cash Flow Swap had *"a positive mark-to-market for Deutsche Bank which, at the time the transaction is entered into, considers the negative mark to market of the "Interest Rate Swap – Mirror Trade" transaction."*

66. Following from this:

i) DB's variable rate payments under the Cash Flow Swap at Euribor + 0.115% were based on an initial notional amount of €30,465,470 (i.e. the amount of Busto's underlying variable rate borrowing) amortising to zero by 31 December 2027 (when Busto's variable rate borrowing was due to be repaid), whereas Busto's variable rate payments were based on an initial notional amount of €55,041.118 (i.e. the total amount of Busto's underlying borrowing at either a variable rate or fixed rate); and

ii) The fixed payments to be made by DB to Busto under the Cash Flow Swap were approximately €12 million higher than the fixed payments from Busto to DB. This reflects the fact that the fixed interest coupons paid by DB were calculated on an initial notional amount which was equal to the amount of Busto's underlying fixed rate borrowing amortising to zero by 30 June 2031 (when Busto's fixed rate borrowing was due to be repaid). It is these fixed interest coupons which make up an additional €12 million of fixed payments that are

payable by DB to Busto over the full term of the Cash Flow Swap and which has been discussed in the course of trial.

67. The principal exchange element of the fixed payments therefore nets to zero, after the amount of the fixed payments attributable to fixed interest coupons in respect of Busto's underlying fixed rate borrowing is removed from the fixed payments. The suggestion made by Busto that there was a €12 million premium is therefore erroneous and is based on a false premise.

68. The economic effect of the Cash Flow Swap is that Busto swapped the interest that it was paying on its variable rate and fixed rate borrowing for the collared variable rate. Meanwhile DB pays the interest on Busto's variable rate borrowing (and, indeed, the interest on Busto's fixed rate borrowing). The Transactions would "smooth" Busto's debt repayments which were budgeted to be high in the period 2007-2014.

69. There was however a price: Busto, by contracting for a floor rate, might find itself paying a higher interest rate than would have been applicable under the variable rate borrowings. At the same time the floor rate under the Cash Flow Swap was lower than the average rate on Busto's underlying fixed rate borrowing (and even more so on its underlying borrowing from Cassa Depositi e Prestiti).

70. Busto has thus benefitted from the fall in Euribor to the extent of the difference between its average fixed rate and the floor rate of the Cash Flow Swap. But as matters have eventuated interest rates have fallen below the floor rate. The consequence of this is that Busto's overall interest costs remain fixed at the level of the floor. The net differentials payable by Busto to DB under the Cash Flow Swap increase as interest rates fall below the level of the floor; thus if interest rates fell to zero (and in fact from December 2015 to date 6m Euribor has been negative) Busto would be paying interest at 4.7% on notional sums of tens of millions of euros in exchange for just 0.115%: an interest differential of around 4.6%.

71. The projected cumulative differentials at the time of entry into the Transactions were that in respect of the principal exchange elements Busto would benefit from the Transactions to the tune of around €7.3m by mid-2021. While the details of exactly how different the outcome is to what was envisaged are unclear, there is no doubt that the transaction has proved markedly less beneficial for Busto than this.

72. It is this which underpins Busto's case that this is *"quite clearly a transaction whose success depended on how interest rates rose or fell in the future" and* therefore speculative.

Subsequent events

73. On 27 July 2007, Mr Buono forwarded to Allen & Overy some of the documentation required for the legal opinion. Mr Buono provided further documentation to Allen & Overy on 3rd August 2007 .

74. On 9 August 2007, the confirmation in respect of the Mirror Swap was amended and, on 10 August 2007, Mr Fogliani sent an email providing a copy of this confirmation to the Ministry of Economy and Finance.

75. On 4 October 2007, Mr Buono sent a further email to Allen & Overy attaching further documentation. It is clear from this email that the Bank was dealing with A&O in relation to several transactions involving Italian local authorities at this time.

76. In December 2007 and January 2008, A&O provided its "*final advice*" to DB, the contents of which are privileged.

77. By a resolution on 5 May 2008, Busto's City Council approved the annual and multi-year budget, as well as a detailed note (required by Italian law) setting out the financial commitments and charges in respect of derivative contracts. That note described the purpose of the Cash Flow Swap:

> "The purpose was, on the one hand, to change the current concentration of repayment quotas in the short term by redistributing the disbursements over time without naturally extending the final maturity of the debt. In this way it is possible to generate liquidity to be used for the financing of investments by reducing the recourse to new loans. A further purpose was to limit the cost of interest in the event of an increase in interest rates through the presence of a 'cap' on the floating rate and a floor rate (collar structure)."

78. This note also included a comparison of Busto's debt repayment profile before and after the Cash Flow Swap, explaining that the economic effect of the Cash Flow Swap was to reduce Busto's principal repayments by €11.8 million up to 2013, but to require Busto to make higher principal payments in the same amount over the period 2014 to 2031. The note further stated that the principal exchange amounts were fixed, whereas the interest costs would depend on the level of Euribor, and it included a projection of the expected cash flows for Busto over the next 3 years based on the forward curve and the mark to market ("MTM") of the Transactions. A similar note was approved annually thereafter by the City Council.

79. In early 2009 Busto approved an Executive Resolution no. 203/2009 appointing Brady Italia Srl to conduct a financial analysis of Busto's derivative contracts. Three reports followed in April, May and July of that year. In late 2012 by Executive Resolution no 883/2012 Busto appointed Brady to carry out a financial and contractual analysis of the Cash Flow Swap specifically. Brady's report following this second instruction was made on 19 December 2012. It confirmed the initial notional value under the swap noted above.

80. The parties complied with their various payment obligations without complaint until 2018 (and the Mirror Swap therefore came to an end in 2011, after all of the payment obligations thereunder were discharged).

81. Although Busto started making payments to DB under the Cash Flow Swap in July 2013, it was not until January 2018 that Busto became the net payer overall under the Transactions, i.e. that the total payments made by Busto to DB exceeded the total payments previously made by DB to Busto.

82. In early 2018 Busto appointed Martingale Risk Italia Srl ("Martingale") to analyse the Transactions. Martingale produced a detailed report ("the Martingale Report") and sent

it to DB on Busto's behalf on 20 March 2018, along with a letter which declared that the Transactions had been unlawful and requested a refund of the balance paid to DB. The grounds relied on in the Martingale Report are not those pursued before this Court.

83. Busto continued to pay the sums that have fallen due under the Transactions up to and including 30 June 2020. However, on 9 December 2020, the City Board decided by resolution no. 366/2020 to stop making further payments pending resolution of this dispute. Busto has failed to pay the amounts of €778,742.05 and €786,618.74 that were payable under the Cash Flow Swap on 31st December 2020 and 30 June 2021 respectively.

Legal backdrop (English Law)

Swaps in the Courts of England and Wales

84. Although this is a case predominantly concerned with Italian Law, considerable reference has been made by Busto to the approach taken by the English Courts to swaps over the years.

85. The first case in this jurisdiction to analyse the interplay between concepts of freedom to contract and the regulation of local authority finances was *Hazell v Hammersmith & Fulham* [1992] 2 AC 1. In that case Mr Hazell, who had been appointed by the Audit Commission of Local Authorities of England and Wales, challenged the validity of a series of interest rate swaps entered into by Hammersmith and Fulham local authority in the financial years ending 1987-1988. The use of these products by local authorities was not unique: the evidence was that 77 local authorities out of 450 principal local authorities entered into about 400 swap transactions, nearly all between 1987 and 1989.

86. The case concerned whether the local authority had capacity to enter into interest rate swap transactions and in particular whether the power to do so was conferred by section 111 of the Local Government Act 1972 which provided, insofar as was material:

> "(1) Without prejudice to any powers exercisable apart from this section but subject to the provisions of this Act … a local authority shall have power to do any thing (whether or not involving the expenditure, borrowing or lending of money or the acquisition or disposal of any property or rights) which is calculated to facilitate, or is conducive or incidental to, the discharge of any of their functions."

87. The Divisional Court had held all of the transactions to amount to speculation on future interest rate movements. The Court of Appeal allowed the appeal in part. Mr Hazell therefore appealed to the House of Lords.

88. In the House of Lords, Lord Templeman explained that the interest rate swap emerged as a financial product from about 1981. That the products involved speculation was explained by Lord Templeman at pp.25C-F:

> "If a local authority borrowed £10m. in 1986 for five years at 10 per cent. per annum and LIBOR in 1987 was 12 per cent., the local authority would be unlikely to contemplate a swap. But if

> in 1987 LIBOR was 10 per cent. and the local authority believed that LIBOR would fall to eight per cent., the local authority might be minded to enter into a swap. In that event the local authority would agree to pay a bank LIBOR every year and the bank would agree to pay interest at 10 per cent. on a notional sum of £10m. until 1991. If in 1988 LIBOR fell to eight per cent., the bank would pay the local authority £200,000 being the difference between the LIBOR of eight per cent. and the fixed rate of 10 per cent. on £10m. The local authority must still pay interest at 10 per cent. on the sum of £10m. actually borrowed in 1986 but the gain of £200,000 from the bank would be available to meet the interest payment. If in 1988 LIBOR instead of falling to eight per cent. rose from 10 per cent. to 12 per cent., the local authority would pay the bank £200,000 and would also be bound to discharge the interest at 10 per cent. due on the sum borrowed in 1986. The success of the swap "replacing" the fixed rate of 10 per cent. by LIBOR would depend on LIBOR falling below 10 per cent. and on average remaining below 10 per cent. until 1991."

89. The measure of speculation was because the success of the transaction could only be measured by reference to whether interest rates had moved in line with expectations. As Lord Templeman put it at p.25H:

> "A swap transaction is successful if a rise or fall in interest rates is correctly forecast; once the forecast has been proved to be accurate the local authority can consolidate the gain thus made by a reverse swap. But if after any swap transaction entered into in anticipation of a fall in interest rates there is a rise in LIBOR or if after any transaction anticipating a rise in interest rates there is a fall in LIBOR the local authority will suffer a loss which will be payable in addition to the net interest payable under the terms of the original borrowing."

90. Lord Templeman explained that a local authority might use swap transactions in three different ways:

> "Firstly, a swap transaction could be agreed which was not linked to any underlying borrowing, for example it could enter into an agreement to pay LIBOR and receive a fixed rate of 10 per cent. If the swap transaction was affected by reference to a notional principal sum of £100m. and LIBOR fell to nine per cent, the local authority would make a profit of £1m. If LIBOR rose to 11 per cent. the local authority would lose £1m.
>
> Secondly a local authority that had borrowed £10m. at a fixed rate of 10 per cent. and believed that interest rates were falling, could enter into a swap agreement to pay LIBOR and receive 10 per cent. If LIBOR fell to nine per cent. the local authority would make a profit of £100,000. If LIBOR rose to 11 per cent. the local authority would lose £100,000. This was referred to as a "parallel

> contract" said to "replace" the original interest payment obligation.
>
> Thirdly, a local authority might seek to increase the proportion which its variable interest rate obligations bore to its fixed interest obligations. If 90 per cent. of the local authority's borrowings were at fixed rates of interest and 10 per cent. at variable rates, the local authority might by swap contracts agree to pay fixed interest and receive LIBOR and thus increase the proportion of its variable interest obligations. This process was called "re-profiling.""

91. In the House of Lords it was the status of the second and third categories of swap transactions that was in issue, the banks arguing that, , they were within the letter of section 111 being transactions *"calculated to facilitate"* or *"conducive to"* or *"incidental to"* the discharge by the local authority of its admitted function of borrowing or an alleged function of debt management.

92. Lord Templeman rejected the argument that the contracts were *"akin to insurance"* and found that they were speculative:

> "But the success of swaps depends on a successful forecast of future interest rates. The power of a local authority to choose between long-term and short-term borrowings and to choose between variable and fixed interest rates, and the power of a local authority to borrow from the P.W.L.B. on favourable terms and to change from variable to fixed rates of interest and the power of the local authority to replace a borrowing with another borrowing, provide opportunity for the local authority to consider whether the overall rate of interest paid by the local authority is reasonable and is protected against volatility of interest rates. The greater the volatility of interest rates, the greater the risk of loss to a local authority as a result of swap transactions. Despite the urgings of counsel for the banks to the contrary, it seems to me there are substantial risks."

93. Lord Ackner put the position more trenchantly still:

> "The purpose and function of swap transactions is not to facilitate, to help, or to make more easy the discharge by the local authority of its function of borrowing. The original underlying debt or debts continue in existence and are all unaffected by the swap transactions. In many cases the swap transactions are entered into long after the underlying borrowing and probably were not even in contemplation when such borrowing took place. The function and purpose of the swap transactions is to alleviate the consequences of borrowing by the local authority purchasing what has been conveniently called "a stream of income" or "a cash flow" which will enable it to reduce the nett cost of its borrowing. In the words of Mr. Sumption, appearing for Barclays Bank, interest swap transactions are "a risk mitigating

> activity." They are designed not to meet any specific loss but to seek to ensure that the local authority pays as little interest on its loans as can be achieved. In this respect they are indistinguishable from any other transaction which involves the hope of gain, which gain is intended to reduce a risk attendant on an underlying transaction. Although the phrase "debt management" may be a convenient one, swap transactions in fact leave the debt wholly unmanaged. Even in the most limited form of "hedging" the swap transaction involves the local authority incurring the following risks. (1) That the movement of interest rates will be contrary to what is anticipated, with the result that the local authority will have wasted the transaction costs, that is the money paid to its brokers for arranging the swap. (2) The credit risk that the opposite party to the transaction may default."

94. The House of Lords judgment was not well received by the banking community. In the Bank of England, Final Report of the Legal Risk Review Committee (1992), at paragraphs 23 it was said that:

> "If markets in this country [United Kingdom] are to continue to flourish and innovate as successfully as they have in the past, it is essential that participants should be as certain as they can be that what they are doing will be upheld by the law."

95. Similarly in *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] AC 669 Lord Goff noted that:

> "I wish to record that [the House of Lords decision in Hazell] caused grave concern among financial institutions, and especially foreign banks, which had entered into such transactions with local authorities in good faith, with no idea that a rule as technical as the ultra vires doctrine might undermine what they saw as a perfectly legitimate commercial transaction."

96. Nonetheless in this and other cases such as *Kleinwort Benson Ltd v Lincoln City Council* [1999] 2 AC 349, the decision was followed, with the result that the transactions had to be reversed out.

97. The first wave of cases that followed *Hazell* raised other grounds upon which the authorities challenged the lawfulness of their own transactions in other contexts. At times these challenges were regarded as unattractive. As Peter Gibson LJ said in *Stretch v West Dorset CC* (Nov. 11, 1997):

> "…I would dismiss this appeal. I do so with little satisfaction. It seems to me unjust that when public bodies misconstrue their own powers to enter into commercial transactions with unsuspecting members of the public, those bodies should be allowed to take advantage of their own errors to escape from the unlawful bargains which they have made. For a local authority to assert the illegality of its own action is an unattractive stance for it to adopt. It is the more striking when, as in this case, the

> transaction in question is as mundane as a building lease; and the local authority, by taking the point against the member of the public with whom it or its predecessor contracted, thereby robs that member of the public of part of the consideration for entering into the lease."

98. However over time the approach of the courts in this jurisdiction has been modified. The criticisms of the ultra vires doctrine led to incremental legislative reforms, such as the Localism Act 2011 which introduced a "*general power of competence*". Braithwaite describes it as having *"fundamentally shifted the central presumption in this area of law"*.

99. In what might be called the second wave of cases, issues of capacity as regards local authorities from many jurisdictions have been raised. These include *Haugesund Kommune and another v Depfa ACS Bank* [2012] QB 549 (in which Norwegian local authorities had entered into swaps with a view to making profits which could be used to improve local services) and a number of other cases involving Italian local authorities.

100. Ultimately a line frequently comes to be drawn between speculation and hedging, though it is a distinction which has been derided as elusive, unsatisfactory or even as tending to distract. This can be seen in *Standard Chartered Bank v Ceylon Petroleum Corpn* [2011] EWHC 1785 (Comm), a case where a statutory corporation entered into swaps in an attempt to protect itself against an oil price rise and later challenged the validity of the swaps when the oil price actually collapsed.

101. A key passage is at [340-347] where the expert evidence on this subject was summarised by the trial judge Hamblen J:

> "[340] As SCB's derivatives expert, Ms Bossley pointed out in the Joint Expert's Report:
>
> '. . . at the extreme ends of the spectrum it is clear what is hedging and what is speculating. In the middle of the spectrum there is a grey area where the same action can be hedging or speculation depending on the context, including the party's intention. The existence of a physical position makes it more likely that any particular action involves hedging.'
>
> As further pointed out in a paper of Professor Hieronymous of the University of Illinois in a paper exhibited to the expert report of Mr Begnini, CPC's derivatives expert:
>
> 'This (a suggested definition of hedging) assumes that 'hedging' and 'speculation' are at least different, if not opposite. They are not. All hedges are more or less speculative, and all speculative positions are more or less hedged.' …

> Mr Begnini accepted that there is no single definition of hedging. However, he identified various matters which he considered to be indicative of hedging, and various matters which he considered to be indicative of speculation. Such an approach effectively admits that there is no straight-forward dividing line, but that at best a judgmental approach is required where various factors are to be weighed in the balance.
>
> The main indicators of hedging which he stressed were:
>
> '(1) Hedging is concerned with a risk that the hedger actually faces.
>
> (2) That risk may have a negative impact on the hedger.
>
> (3) A hedge reduces the risk faced.
>
> More specifically:
>
> 'hedging is an activity undertaken by companies attempting to take control of their own cash flow by ironing out price spikes and troughs in their oil acquisition or sales contracts. Its objective is to reduce future oil price uncertainty and may be seen as having a risk reducing motivation.'
>
> All this is achieved by an offsetting transaction. Hedging involves an entity establishing a 'paper' position by purchasing derivative instruments which offset price movements in a market to which it is exposed (the entity's 'physical' position). Thus, for example, an oil importer will hedge the cost of its oil imports (its physical position) by purchasing derivative instruments (its paper position) which offset movements in the price of its oil imports. As the price of its oil import costs increase, the importer will receive payments under the derivative instruments that offset these increases.
>
> Mr Begnini stressed that the objective of a hedger is to remove risk and increase certainty, rather than to make profits. Conversely, a speculator will trade with the objective of achieving profits through the successful anticipation of price movements and will take on risk in order to generate profits from anticipating market movements."

102. Further discussion of this distinction can be found in *Banco Santander Totta SA v Companhia de Carris de Ferro de Lisboa SA* [2016] EWHC 465 (Comm) | [2016] 4 W.L.R. 49 at [222-235] (unappealed on this point).

103. There has also been consideration of the approach to be taken to questions of capacity. In *Haugesund* Aikens LJ said at [47]:

> "…in what sense must we interpret the word "capacity" in Dicey's rule? … How the word "capacity" is interpreted for the purposes of the rule is, as Etherton LJ has stated in his judgment, ultimately a matter of policy. In my view it is important to remember the purpose of the rule, which is to determine which systems of laws will be used, under English conflicts rules, to decide whether a "corporation" has the ability to exercise the legal right to enter into a binding contract with a third party. If that accurately summarises the rule's purpose, then I think, … that the concept of "capacity" has to be given a broader, "internationalist", meaning and must not be confined to the narrow definition accorded by domestic English law. In my view it should be interpreted as the legal ability of a corporation to exercise specific rights, in particular, the legal ability to enter a valid contract with a third party. So I agree with the approach of Tomlinson J; for the purposes of English conflicts of laws, a lack of substantive power to conclude a contract of a particular type is equivalent to a lack of "capacity", to use English terminology."

The Approach to Foreign Law

104. Another important background question is the approach which I should take to the considerable amount of Italian Law expert evidence.

105. I was referred to *MCC Proceeds Inc v Bishopsgate Investment Trust PLC* [1999] CLC pp 417 and 424 for a helpful discussion as to the approach that an English judge should adopt when making findings of foreign law. In *Banco Santander v Totta*, Cranston J then drew on this judgment in the context of cases where the law in question was a civilian as opposed to a common law system. At [237] he said:

> "The court 'is not entitled to construe a foreign code itself' (*Lazard Bros & Co v Midland Bank Ltd* [1933] AC 289 at p 298 (Lord Wright)).
>
> (7) Even when there is a proved or agreed translation, "it is still primarily the function of the expert witness to interpret its legal effect, in order to convey to the English court the meaning and effect which a Court of the foreign country would attribute to it, if it applied correctly the law of that country *(A/S Tallinna Laevauhisus v Estonian State Steamship Line* [1946] 80 Ll L Rep 99 at 108 (Scott LJ)).
>
> (8) The "function of the expert witness in relation to the interpretation of foreign statutes must be contrasted with his function in relation to the construction of foreign documents. In the former case, the expert tells the court what the statute means, explaining his opinion, if necessary, by reference to foreign rules of construction. In the latter case, the expert merely proves the foreign rules of construction, and the court itself, in the light of these rules, determines the meaning of the documents"

> (*Alhamrani v Alhamrani* [2014] UKPC 37 at [19] (Lord Clarke) approving Dicey, Morris & Collins, ibid, at p 9–019).
>
> (9) As to the identification of judgments and other authorities, the court "is not bound to apply a foreign decision if it is satisfied … that the decision does not accurately represent the foreign law" (Dicey, Morris & Collins ibid at p 9–020). In addition, "where foreign decisions conflict, the court may be asked to decide between them, even though in the foreign country the question still remains to be authoritatively settled" (ibid at p 9–020).
>
> (10) It is evident that the quality of expert evidence before the court varies from case to case, and the above principles have to be applied in that light. As has been held in the context of the construction of foreign statutes, the degree of freedom which the English court has in putting its own construction on the translation of foreign statutes, arises out of, and is measured by, its appraisal of the expert evidence. …
>
> (13) However, as the claimant submits (correctly in the court's view) in that case the Court of Appeal was discussing a jurisdiction (the United States) where the doctrine of precedent exists. Where there is a precedent, there may not be much scope in practice for opinion evidence. That is not, however, the position in a civil law jurisdiction like Portugal. As the evidence shows, in Portugal there are conflicting decisions even at the level of the Supreme Court of Justice and decisions where lower courts have rejected an approach previously adopted by a higher court. Thus, even if there is a decision directly on point, the English court may need to consider what a future court would decide."

106. The central question here of course is the extent to which it is open to me to diverge from the decision in *Cattolica* in particular given its status as a decision of an ultimate court of appeal in Italy. In this connection reference was made by Busto to the judgment of Walker, J in an earlier Italian swaps case, *Dexia Crediop S.p.A v Comune di Prato* [2015] EWHC 1746 (Comm) at [128]:

> "The task for the Court is to evaluate the expert evidence of Italian law and to predict the likely decision of the highest court in the relevant Italian system of law if this case had been litigated there on each of the points in dispute. As explained below, these courts are the Council of State for administrative law matters and the Court of Cassation for civil law matters".

107. In this connection I also bear in mind the following passage from *Guaranty Trust Company of New York v Hannay* [1918] 2 K.B. 623, 638-639:

> "It seems to me that we must consider whether in our opinion this decision was correct, and must consider it as a question of

> fact upon the evidence. If this were not so, evidence as to foreign law would be useless wherever there was a decision of any foreign judge on the point, and our Courts could only follow that decision as a binding authority. This is not the position of our Courts in such a matter. It may be that we have, strictly speaking, the same power to consider a decision of the ultimate Court of Appeal, but I cannot imagine that an English Court would hold a decision of the final Court of Appeal in the State of New York erroneous according to the law of that State."

108. I conclude that it is open to me to diverge from even the highest authority, particularly in the context of a civilian law system. For example if, on the evidence I can be satisfied that an authority, however eminent, does not represent the law – if for example a foreign court has unwittingly diverged from a long established approach to a particular issue. However I must be astute to give full weight to that judgment before concluding that that is the correct course and that in future an Italian court confronted with this issue would diverge from that high authority.

The relevant Legislative Provisions

109. The general civil law capacity of Italian local public bodies, such as Municipalities, is derived from and reflected in Article 11 of the Italian Civil Code, which provides:

> "Provinces and the Municipalities, as well as public bodies recognised as legal persons, enjoy rights according to the laws and uses observed as public law."

110. It is also confirmed by Article 1(1-bis) of the Law no. 241/1990 ("Article 1(1-bis)"), which provides:

> "The public administration, in adopting measures of a non-authoritative nature, acts according to the rules of private law unless the law provides otherwise."

111. Article 12(1) of the Italian Civil Code provides:

> "In the application of the law, it shall not be attributed to it any meaning other than the one made obvious by the proper meaning of the words in accordance with the connection between them, and by the intention of the legislator."

112. Article 119 of the Constitution is one of the key provisions in focus on the expert evidence. In 2007 Article 119 provided, so far as material, as follows:

> "(1) Municipalities, Provinces, Metropolitan Cities and Regions shall have financial autonomy in terms of revenue and expenditure.
>
> (2) Municipalities, Provinces, Metropolitan Cities and Regions shall have independent financial resources. They set and apply taxes and revenues of their own, in compliance with the

> Constitution and according to the principles of coordination of State finances and of the tax system. They have co-participation in the tax revenues related to their respective territories. …
>
> (4) Revenues deriving from the above mentioned sources shall enable Municipalities, Provinces, Metropolitan Cities and Regions to fully finance the public functions assigned to them.
>
> (6)…Municipalities, Provinces, Metropolitan Cities and Regions have their own assets, allocated to them pursuant to general principles laid down in the State law. They may resort to indebtedness only for the purpose of financing investment expenditures. Any State guarantee on loans taken out by them is excluded."

113. The next relevant provision is Article 41(1) of Law no. 448/2001. This was in the following terms at the time of the Transactions:

> "In order to contain the cost of debt and to monitor public finance developments, the MEF[2] coordinates access to the capital markets of the provinces, municipalities, unions of municipalities, metropolitan cities, mountain communities and island communities … as well as consortia of local authorities and regions. To this end, these entities regularly send data on their financial situation to the Ministry. The content and data coordination and transmission methods are established by decree of the MEF to be issued jointly with the Ministry of the Interior, after consultation with the Unified Conference referred to in article 8 of Legislative Decree no. 281 of 28 August 1997, within thirty days from the date of entry into force of this law. The same decree approves the rules on debt amortisation and on the use of derivatives by the above entities."

114. Article 3(17) of Law no. 350/2003 refers to indebtedness in these terms:

> "For entities, referred to in paragraph 16 above, pursuant to article 119(6) of the Constitution, the following constitute indebtedness: [list of various items constituting indebtedness]. …Operations that do not involve additional resources, but permit to overcome, within the maximum limit established by current State legislation, a temporary shortage of liquidity and to incur expenses that already have a suitable budget cover, do not constitute indebtedness, pursuant to the aforementioned article 119".

115. Article 3(17) was amended, with prospective effect only from 1 January 2009, so as to provide that indebtedness includes *"premiums received at the conclusion of derivative contracts"*.

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[2] Ministry of Economics and Finance

116. Article 41(1) of Law no. 448/2001 made provision for a ministerial decree to be issued setting out, *inter alia*, *"the rules ... on the use of derivatives"*. Rules were duly set out in Ministerial Decree 389/2003. This was in force in 2007 and it is common ground that it applied to derivative contracts entered into by Municipalities, such as Busto.

117. Article 3(2) of the Decree set out a list of permitted derivatives, as follows:

> "In addition to the transactions referred to in paragraph 1 of this article and article 2 of this decree, the following derivative transactions are also allowed:
>
> a) interest rate swap between two parties taking the commitment to regularly exchange interest flows connected to major financial market parameters according to the procedures, timing and conditions stated in the contract;
>
> b) purchase of a forward rate agreement in which two parties agree on the interest rate that the buyer agrees to pay on a capital at a future date;
>
> c) purchase of an interest rate cap in which the buyer is protected from increases in the interest rate payable above the set level;
>
> d) purchase of an interest rate collar in which the buyer is guaranteed an interest rate to be paid, fluctuating within a pre-determined minimum and maximum;
>
> e) other derivative products containing combinations of the above that enable the transition from a fixed rate to floating rate and vice versa when a predefined threshold has been reached or after an established period of time;
>
> f) other derivative products aimed at restructuring debt, only if they do not have a maturity subsequent to that of the underlying liabilities. These transactions are allowed when the flows received by the interested bodies are equal to those paid in the underlying liabilities and do not involve, at the time of their conclusion, an increasing profile of the present values of single payment flows, with the exception of a discount or premium to be paid at the conclusion of the transactions, not exceeding 1% of the notional of the underlying liability."

118. On 22nd June 2007 the Ministry of Economics and Finance (Treasury Department) published the following circular ("the MEF Circular")

> "Circular of 22 June 2007, published in the Official Gazette of 2 July 2007 no. 151….
>
> 1) …
>
> Following the legislative amendments that occurred on derivative instruments and on the definition of indebtedness, and

> also in light of the evolution of local authorities' resorting to the derivatives market, there is the need to clarify some interpretative aspects regarding the use of delegations of payment disciplined by Article 206 of the Local Authorities' Consolidated Act (TUEL) – Legislative Decree of 18 August 2000, no. 267.
>
> It seems appropriate to remind that the explanatory Circular of the MEF Decree 389/2003 already included a general consideration such that no derivative is classifiable as a liability.
>
> Therefore, derivatives are identified, according to the rules mentioned above, as "debt management instruments and not as indebtedness".
>
> 2) Article 3, paragraph 17, Law of 24 December 2003, n .350, amended by Article 1, paragraph 739, Law of 27 December 2006, no. 296 – Definition of indebtedness
>
> Article 119, sixth paragraph, of the Constitution indicates that "Municipalities, Provinces, metropolitan cities and Regions […]. May resort to indebtedness only to fund investment expenses. […]". In the implementation of this constitutional principle, the 2004 Financial Law (Law 350/2003) gave a precise and detailed definition of the concept of indebtedness, indicating the types of transactions to be considered as such in reference to the abovementioned constitutional law….
>
> In conclusion, the definition of swap as mere instrument of debt "management" is further confirmed by the fact that derivative instruments are not mentioned in any of the abovementioned provisions of law; therefore, in light of the above, derivative instruments do not qualify as indebtedness transactions."

119. I should note here the point made by Mr Downes for Busto that unlike the earlier provisions in this section this last document is not a piece of legislation, but rather a circular, not adopted by a minister, and not binding on regions and municipalities.

The *Cattolica* decision

120. There is one Italian case which is of huge importance in the context of this case. It is the *Cattolica* decision. It has formed a central plank of the arguments as to capacity. It is also highly relevant to three specific substantive areas (which Busto say go to capacity and Deutsche Bank say – if they exist – do not constitute limits on Busto's capacity):

    i) The question of whether the mark to market and probabilistic scenarios were required to be provided by DB to Busto;

    ii) The question of whether there is a divide between hedging and speculation;

iii) The question of whether there is a requirement that the City Council approves such transactions.

121. A detailed account of the case is therefore vital.

122. In 2003 and 2004, the Italian Municipality of Cattolica (a small town and comune in the Province of Rimini, Italy), purported to enter three interest rate swap transactions with Banca Nazionale Del Lavoro S.p.A ("BNL"). By their terms, the three swaps were to run until 2016, 2023 and 2024 respectively. The swaps were governed by Italian law. They were not ISDA Master Agreement swaps.

123. The first two swaps (the second swap being an amendment of the first) contained "*up-front clauses*" under which the Municipality of Cattolica was paid €315,000 in respect of the first swap and €655,000 in respect of the second swap. The third swap (like the two swaps in issue in the present case) did not involve any upfront payment by BNL to the Municipality. None stated MTMs, probabilistic scenarios or referred to underlying loans.

124. Cattolica's City Council passed a resolution dated 27 March 2003 that established a "*guideline*" appointing the competent bodies to verify the possibility of improving the Municipality's liability management, including using swaps. Thereafter, there was a second resolution of the City Board dated 14 May 2003 and relevant officers (in respect of the first swap), and executive decisions in respect of the others. There was no decision by the City Council approving the terms of the swaps themselves.

First Instance: Case No. 5244/2009: The Court of Bologna

125. The Municipality of Cattolica commenced proceedings before the Court of Bologna seeking a decision that the three swap transactions were null and seeking an order for the return of payments made pursuant to the three (void) transactions. The claim was made based on, *inter alia*, Article 119(6) of the Italian Constitution, and Article 42(2)(i) of the Consolidated Code of Local Bodies.

126. The claim of the Municipality was dismissed at first instance by the Court of Bologna. In summary (and to the extent relevant to the present dispute), the Court found that the three swap contracts could not be considered as forms of indebtedness - with the consequence that Article 119 of the Italian Constitution and Article 42(2)(i) of the Consolidated Code of Local Bodies were not breached.

On Appeal to Court of Appeal of Bologna: Case No. 734/2014

127. The Municipality of Cattolica appealed. The seven grounds of appeal relied upon by the Municipality are set out at paragraphs 2.1 to 2.7 of the judgment of the Court of Appeal of Bologna. In summary they were:

i) The up front clause transformed the "pure" swap into a mixed cause contract;

ii) The guideline passed by the City Council did not have the requisite content under Article 42(2)(i) and Article 192 of the Consolidated Code of Local Bodies;

iii) The contracts did not contain any indication of the underlying "swapped" loans;

iv) Swaps were permissible only in respect of simultaneous and not pre-existing loans;

v) The contracts did not comply with the provisions of Ministerial Decree No 389;

vi) The Municipality was not a qualified investor;

vii) The consequence of the Municipality not being a qualified investor was that the contracts were void since there was no mention of the Municipality's statutory right of withdrawal.

128. The Court of Appeal allowed the Municipality's appeal. In doing so, the Court of Appeal of Bologna found, *inter alia* that:

i) There had been a breach of Article 42(2)(i) of the Consolidated Code of Local Bodies because the swap transactions could only lawfully be entered into by the Municipality if they were approved by a decision of the City Council. Since there had been no such decision, the swaps were void;

ii) There had been a breach of Article 119(6) of the Italian Constitution because there was actual or potential indebtedness inherent in the three swap transactions and the Municipality had not resorted to this indebtedness for the purpose of financing investment expenditure;

iii) There had been a breach of Article 1346 of the Italian Civil Code because none of the three swap contracts contained a specific reference to the underlying loans in respect of which the swap contracts were executed.

129. In reaching its conclusions on Article 119(6) of the Italian Constitution and Article 42(2)(i) of the Consolidated Code of Local Bodies, the Court of Appeal of Bologna:

i) Upheld the claim by the Municipality that, because of their aleatory nature, all three swaps constituted a form of actual or potential indebtedness for the authority;

ii) Added that none of the three swaps contained a determination of their value when executed (the 'mark to market'), which careful and meritorious case law of the lower courts held was "*an essential element thereof and thus constituting its required typical purpose/function [causa tipica] (rational and thus measurable degree of uncertainty [alea] which must necessarily be made explicit, regardless of its hedging or speculative function)*";

iii) Observed that the fact that the law provision expressly categorising the upfront as indebtedness (Law No. 133 of 2008) came into effect after the swap contracts in issue were entered did not mean that the upfront payments could not in any event be interpreted as indebtedness.

130. BNL sought to appeal the judgment of the Court of Appeal of Bologna. In 2020 the Joint Civil Divisions of the Italian Supreme Court delivered a landmark judgment dismissing BNL's appeal.

The Supreme Court

131. On 23rd October 2018, the First Civil Division of the Italian Court of Cassation/Supreme Court (to which I refer as the Supreme Court) made an Interlocutory Order referring BNL's appeal to the First President for him to consider assigning it to the Joint Divisions of the Supreme Court for determination.

132. Having summarised the issues raised by the appeal, the First Civil Division stated the following at paragraph 12 of the Interlocutory Order:

> "This Court believes that the issues above are of great importance …: apart from being of great relevance from a practical point of view, due to the concrete effects that the adopted solutions will have in the context of the litigation on derivatives between local bodies and financial intermediaries (a litigation that often involves very large sums of money), they relate to matters on which the Court of Auditors, in both its jurisdictional and administrative articulation, and the Council of State, have given conflicting responses. Therefore, the relevance of these issues arises from a scenario of serious uncertainty as it results from the decisions of the various judicial bodies that have dealt with them in auditing, accounting liability and self-protection matters. This Court is obviously aware that in the case before it there are subjective rights involved, which were absent in the cases brought before the Court of Auditors and the Council of State; nonetheless, it thinks that there is a need to avoid in the future conflicting judgments by the first section of the Supreme Court on a fundamental topic for the interest of the local bodies and the banking and financial intermediaries, on which the signalled disagreements have already had an impact."

133. It follows that the decision in *Cattolica* in the Supreme Court is a decision of that court sitting in joint divisions. I accept that one reason for that unusual course was a desire to resolve uncertainty. I accept that other Italian courts would give it particular weight; and I do likewise.

134. At paragraph 4.1 of the Supreme Court's decision the Court noted that the first three grounds of appeal raised two questions:

> "that were closely connected and crucial for assessing the validity of swap contracts entered into in general by Municipalities: a) the question of whether the assumption of the obligation by the local entity entering into the contract, involving the named derivative, could be categorised as indebtedness intended to finance non-investment expenditures; and b) the question of determining the body required to authorise such a transaction (which, in this case, was regulated by the city council by means of mere "guidelines")."

135. It then went on at paragraph 4.2 to note that the issues referred were:

> "a) "whether the swap, particularly the swap that included an upfront – and not governed (based on when it became effective)

> by Italian Law No. 133 of 2008, which converted Italian Decree-Law No. 112 of 2008 – constitutes, for the local entity, a transaction that results in indebtedness to finance non-investment expenditures pursuant to Article 30, paragraph 15 of Italian Law No. 289 of 2002"; and b) "whether the execution of the related contract falls within the authority reserved for the City Council, since it entails an expenditure decision that affects budgets for subsequent financial years, pursuant to Article 42, paragraph 2, letter i) of the T.U.E.L."."

136. The decision however ranges much wider than these two narrow issues.

137. The substantive part of the Supreme Court Judgment (under the heading Reasons for the Decision) consists of 10 sections. These provide in summary as follows:

   i) Section 1 sets out the five grounds of appeal against the Court of Appeal judgment relied upon by the bank;

   ii) Section 2 sets out the ground of the Municipality's conditional cross-appeal. That has no relevance to the issues in this action;

   iii) Section 3 refers to the Interlocutory Order and the issues raised by it;

   iv) Section 4 contains an analysis of the "*topic of derivatives*", with a particular focus on the interest rate swap (IRS). The section of the judgment also describes certain market concepts, most significantly mark to market;

   v) Section 5 of the judgment considers the function/purpose of a swap;

   vi) Section 6 of the judgment addresses "*the validity of the contractual instrument that contains*" the swap;

   vii) Section 7 of the judgment begins: *"After these necessary preliminary clarifications, we can proceed with examining the issue (which is the basis of the questions posed by the division that referred the matter to these Joint Divisions) relating to the execution of derivatives, swaps and IRSs by public entities in general and local entities in particular"*. Section 7 of the judgment then goes on to address the constitutional and statutory framework that governs the entry into derivative contracts by Italian local authorities, explaining how that statutory framework has changed over time;

   viii) Section 8 of the judgment begins by stating: "*The Court notes that the aforementioned changes in the law, while turbulent and not always linear, make it possible to conclude that, even during the period that Article 41 of the 2002 Budget Law was in effect and, thus, until 2008 (the year the legislature imposed more stringent limits on entities' ability to enter into derivatives) the contractual power of local entities had clear limitations*";

   ix) What is being addressed at Section 9 of the Supreme Court's judgment is highly controversial between the parties and is a specific topic of expert evidence. It begins as follows (at paragraph 9):

> "However, that does not fully solve the problem brought to the attention of these Joint Divisions, since we must – within the ambit of the path theoretically admissible – determine whether other limits exist on the lawfulness of those contractual types for the Public Administration"

x) Section 10 of the judgment addresses the two remaining grounds of appeal. This section of the judgment is introduced by the court stating (at paragraph 10):

> "However, that does not fully solve the problem brought to the attention of these Joint Divisions, because of the remaining grounds (1 and 2) of the appeal, which involve the problem of the indebtedness of public entities and the authority to decide in relation to the same".

138. These latter three sections are highly controversial and are dealt with separately below.

Section 8

139. At paragraph 8.1, immediately following its statement that the contractual power of local entities had clear limitations, the Supreme Court states: "*Above all, to be permissible, the derivative had to be financially cost effective, since entering into speculative derivatives was prohibited*". In the same paragraph, the Supreme Court cites the decision of the Italian Constitutional Court in *Decision No. 52/2010* as clarifying that the prohibition on entering speculative contracts can be attributed, in the first instance, to paragraphs 4 and 6 of Article 119 of the Constitution which, respectively, impose the constraint of financial balance and require that indebtedness be for the purposes of investment.

140. At paragraph 8.2 of the judgment (having just stated that to be permissible a derivative had to be financially cost effective), the Supreme Court states this:

> "Derivative contracts, because they are aleatory, could not per se be entered into by the Public Administration, because their aleatory nature is highly inconsistent with the rules relating to public finance and they introduce variables that are not compatible with the fixed nature of expenditure commitments. Therefore, we must conclude that the law provisions examined above, which contemplated those possibilities, only allowed what, normally, would be prohibited, with the result that those provisions were, above all, exceptional and had to be narrowly interpreted, having made the derivatives concluded by the public administration as contracts expressly provided for by the law, as opposed to the unnamed ones entered into by private parties (despite they belong to the same, very broad genus). "

141. At paragraph 8.3, the Supreme Court states:

> "Hence, in light of the legal and axiological framework outlined above, we can arrive at a first conclusion, namely: Recognition of the Administration's capacity to conclude derivative contracts, based on the law in effect until 2013 (when Italian Law No. 147 of 2013 precluded that possibility) and the distinction between hedging and speculative derivatives, based on the criterion of the different degree of risk of each of them, meant that only in the first could a local entity be said to have capacity to enter into them."

Section 9

142. Section 9 starts as noted above with the indication that section 8 does not solve the problem before the Joint Divisions and indicates that it considers that it must "*determine whether other limits exist on the lawfulness of those contractual types for the Public administration*".

143. Paragraphs 9.1 to 9.6 then talk about:

    i) The object of the contract and the validity of the agreement;

    ii) Agreement as to the object not being limited to the MTM criterion but also having to include the probabilistic scenarios and the need to address uncertainty and costs;

    iii) The link between such factors and the financial risk management function.

144. At paragraph 9.7 the court indicates that:

> "Thus, an analysis conducted on a case-by-case basis, using a practical approach, seems to be appropriate. This approach led the court below to acknowledge the sanctioning consequences with regard to those contracts, since a) in none of the examined contracts was there a determination of the value of the contracts when they were executed ("mark to market"), which careful and meritorious case law of the lower courts has held "an essential element thereof and thus its required typical function/purpose [causa] (rational and thus measurable degree of uncertainty [alea]) which must necessarily be made explicit, regardless of its hedging or speculative function"; and b) the potential liability inherent in every swap contract is tangibly and actually manifested in the upfront clause, which was in fact present in two of the three contracts at issue in the case."

145. The section ends as follows (at paragraph 9.8):

> "Based on that analysis, grounds nos. 3, 4 and 5 are groundless and thus must be dismissed, and we must confirm the rule of law as follows:

> In regard to derivative contracts entered into by Italian Municipalities based on the laws in effect until 2013 (when Italian Law No. 147 of 2013 precluded any further use of them) and the distinction between hedging and speculative derivatives, based on the criterion of the different degree of risk of each of them, although local entities could enter into the former with qualified financial intermediaries, local entities could usefully and effectively do so only if the contractual object [oggetto] could be precisely measured/determined, including the mark to market criterion, probabilistic scenarios and the 'hidden costs'. This is to reduce to a minimum and make the entity aware of all of the aleatory aspects of the contract, since they are highly inconsistent with the rules relating to public finance and they introduce variables that are not compatible with the fixed nature of expenditure commitments shown in the financial statements"

Section 10

146. Section 10 of the judgment addresses the two remaining grounds of appeal. This section of the judgment is introduced by the court stating (at paragraph 10):

> "However, that does not fully solve the problem brought to the attention of these Joint Divisions, because of the remaining grounds (1 and 2) of the appeal, which involve the problem of the indebtedness of public entities and the authority to decide in relation to the same".

147. The first issue addressed in Section 10 (at paragraphs 10.1.1 – 10.1.4) is the concept of indebtedness ("*we must take a position on the concept of indebtedness and the concept of the upfront*"). Specifically:

    i) Paragraph 10.1.3 notes that *"Amounts received as an upfront constitute indebtedness for purposes of public accounting law and Article 119 of the Italian Constitution"*;

    ii) Paragraph 10.1.4 makes clear that a swap without an upfront may entail indebtedness. Whether this is the case or not will depend on an examination of the transaction as a whole ("*A swap transaction must be examined as a whole because its effect may essentially amount to indebtedness…*").

148. Paragraphs 10.2 and 10.3 make clear that where the swap contract provides for an upfront payment to the local authority, that will be indebtedness ("*Amounts received as an upfront constitute indebtedness for purposes of public accounting law and Article 119 of the Italian Constitution*").

149. Paragraph 10.2 of the judgment then addresses the municipal body that is required to authorise the use of swaps. It says this:

> "In regard to the municipal body that is required to authorise the use of IRSs, prevailing legal scholars and case law have, rightly, held that the City Council has this authority".

150. Paragraph 10.3 of the judgment refers to Article 42(2)(i) of the Consolidated Code of Local Bodies, which provides the legal basis for the City Council's authority to decide certain matters:

> "More generally, both the case of debt restructuring by Municipalities and the case of their financing by including an upfront clause must be examined. If, in both cases, it involves (or does not) a form of indebtedness and, thus, a matter for the authority of the city council. Since, as is well-known, Article 42, paragraph 2, letter i) of the T.U.E.L provided that "The city council's authority extends solely to the following fundamental actions… expenditures that affect budgets for subsequent financial years, excluding expenditures relating to leases of real estate and ongoing supply of goods and services".

151. At paragraphs 10.4 and 10.4.1 the Supreme Court sets out the policy considerations that support the City Council being required to authorise swap contracts such as those in issue in *Cattolica* (and Busto will say the present case):

> "10.4 In support of the city council's choice, in addition to the substantive terms of those forms of financing, there is also the need to ensure the involvement of the minority members, who are responsible for exercising supervision over the financial transaction. The possibility that the derivative contracts involved in this dispute, although they were concluded by a Municipality with the purpose of renegotiating previous loans on more favourable terms, entail expenses for the administration entering into them, and those expenses impact financial years after the year the contract was executed, is not a remote possibility, but is inherent to the aleatory nature of the transaction.
>
> 10.4.1 The city council must evaluate the cost-effectiveness of transactions that may constrain the use of future resources and make clear that the local entity's transaction must follow the rules of public accounting that govern the carrying out of the responsibilities of entities that use public resources. Therefore, if a Municipality wishes to enter into a debt restructuring transaction, it must identify its main characteristics and the means to implement it and then use a tender proceeding to choose the best offer in relation not only to the goal it seeks to achieve but also the methods it wants to use, since the public administration must conform its actions to principles of affordability and economic cost effectiveness".

152. Paragraph 10.6 of the judgment then states the rule:

> "We must therefore rule that if the IRS concluded by the Municipality affects the total amount of the entity's indebtedness, the financial transaction must, upon penalty of voidness, be authorised by the City Council, keeping in mind that a debt restructuring must be ascertained based on the transaction as a whole, also including – because of the principle of transparency of public accounting – the hidden costs that affect the terms of the swap contract" .

153. At paragraph 10.7 of the judgment, the Supreme Court dismisses BNL's remaining two grounds of appeal:

> "As a result, the appealed judgment cannot be challenged that fully upheld the Municipality's argument that the swap contract and, particularly (but not only) the contract that included an initial upfront clause constituted, because of its aleatory nature, a form of current or potential indebtedness for the public entity."

154. Before passing from this outline of the decision I should deal with one submission which was made for Busto; that is that in order for DB to succeed it would need to *"persuade the Court to disregard or apply strained corrective construction to the following paragraphs in the judgments: 9.7, 9.8, 10.1.2, 10.1.3, 10.1.4, 10.2, 10.3, 10.4, 10.4.1, 10.5, 10.6, 10.7 and 10.8."*.

155. As will appear below I do not accept that submission. I do not consider that the *Cattolica* judgment stands or falls in one piece, as this submission suggests. It is not a question of whether the Italian Courts would, or this court does follow it or refuse to follow it. It is a complex judgment covering (as this precis should have demonstrated) a number of topics. While it avowedly takes in some matters of general principle it is, at the end of the day, a decision in a specific case, whose facts are not the facts of this case. Different passages of the judgment have to be considered discretely in relation to different issues which arise in this case, as I will do below.

The Trial

156. The case has been heard over three Commercial Court weeks, on a hybrid basis. Cross examination of the experts, who were based in Italy, took place remotely. Owing to the need for social distancing the entirety of the legal teams were not able to be present in court. Cross-examination therefore took place in part from Court and in part remotely, depending on each team's preferred approach as offering the least unfairness to each party.

157. Each party called two experts in Italian law – one to deal with administrative law aspects and one to deal with civil law aspects. The experts were as follows.

   i) For the Claimants:

      a) On civil law, Professor Andrea Perrone, a Full Professor of Corporate Law and Financial Regulation at Università Cattolica del Sacro Cuore (UCSC), Milan, Italy and formerly Full Professor of Corporate Law and Comparative Private Law at UCSC, Piacenza, Italy (2004-2010),

Associate Professor of Banking Law at the State University of Ferrara, Italy (2001-2004), and Assistant Professor of Private Law at UCSC, Milan, Italy (1999-2001);

b) On administrative Law, Professor Luisa Torchia, a Full Professor of Administrative Law at the University of Study of Rome "RomaTre", Rome, Italy since 2004. Previously, she held the positions of Full Professor of Administrative Law at the University of Urbino, Department of Political Science (1997-2004), Assistant Professor of Public Law at the University of Urbino, Department of Economics (1994-1997), Assistant Professor of Comparative Administrative Law at the University of Reggio Calabria, Law School (1986-1991), and Researcher in the Institute for regional studies at the National Council of Research (1983-1994).

ii) For the Defendants:

a) On administrative Law, Professor della Cananea, a Full Professor at the Bocconi University (Milan) who has also taught at the University of Urbino (1998-2004) and the “Federico II” University (Naples) (2005-2010). Between 1997-2002, he was appointed by Minister of the Treasury as the Treasury’s legal expert within the governing board of the Cassa Depositi e Prestiti (CDP), a governmental agency providing financial assistance to local authorities. In the years 2013-2018, on appointment by Parliament he was a member of the governing board of the Court of Auditors. In April 2021, he was appointed by the Ministry of the Economy and Finance and the Ministry of Justice as President of the Inter-ministerial Committee for the reform of the Italian fiscal justice;

b) On civil law, Professor Alibrandi. Professor Alibrandi has since 2010 been Professor of Banking Law and Financial Markets Law at the Universita Cattolica del Sacro Cuore, Milan, where she also teaches Civil law. She holds the same position at Univeristy of Piacenza, where she was also the Director of the Law Department. In 2013, she was appointed Vice-Rector of the Università Cattolica del Sacro Cuore in Milan.

158. All of the experts were plainly highly experienced and expert lawyers doing their best to assist the Court and I have been much assisted by their evidence. I am also grateful to them for giving their evidence largely in English, with only very limited assistance from the translator; an approach which I have found extremely helpful. Inevitably I have to take a decision as to which expert’s evidence to prefer; where I have done so I explain below the basis for so doing.

159. In terms of general impression:

i) Professor Perrone was a clear calm witness. He was accepted by Busto to be a reliable witness in relation to matters of Italian civil law;

ii) Professor Alibrandi was a careful expert who readily conceded points against Busto when she considered it appropriate to do so – for example in her evidence on Article 1338 where she was careful to make clear that she agreed with Professor Perrone that Article 1338 aims at rebalancing the asymmetry of information between the parties in a situation where one knows or should have known the law better than the other, because of its professional or institutional status;

iii) Professor Torchia was a clear, good humoured and lively witness. Her exposition of her opinions on the law bore the hallmarks of the experienced teacher. She explained with conviction and particularity the reasons for the issues which she had raised with the *Cattolica* decision. She was scrupulous – so far as Busto was concerned, overscrupulous -not to step outside her own expertise. I do not accept the submission that Professor Torchia was being deliberately obstructive in so doing. To my observation her approach had a good deal of academic rigour about it – (for example when she said *"I don't know anything about loans and contracts. I just know what the public rules are on this. So you can make me assume all kind of contracts, but it's an assumption that I don't understand"*). There was also (consistently) an evident caution not to be drawn into areas where she did not understand matters well (such as mathematics). As I made clear in closing, I do not think that it is unreasonable for an expert academic lawyer to be uncomfortable dealing with propositions founded in mental arithmetic or the mechanics of financial transactions of which she had no prior notice;

iv) Professor della Cananea was mostly equally clear and lively, though his good humour wore somewhat thin as the lengthy cross-examination progressed. He was initially careful to try to answer the question and not to go outside that answer until he had done so. As the cross-examination proceeded however, he had a slight tendency to stray both outside the ambit of the question and the ambit of his expert report;

v) So far as the expert witnesses of Administrative law were concerned therefore there was an interesting clash of evidence between two generally impressive witnesses. Given the clarity and cogency of both experts it was particularly striking that they disagreed about almost every question referred to them.

160. As for the factual witnesses, Ms Villa (for the Bank) and Mrs Marino (for Busto) were both honest and reliable witnesses, and the contrary was not suggested in cross examination.

161. It was also common ground that Mr Danusso was an honest witness, although Busto urges me to treat his evidence with more caution, given his close involvement in fighting this case for the Bank, a longstanding and important client.

162. The most contentious witness was in fact not in the end a witness at all: Mr Tarczynski. At the PTR there was a lively passage of arms about this gentleman's statement, with Busto contending that is should be substantially struck out as being expert evidence under the cover of a factual statement. My own views on the statement were somewhat between those of each party, and I indicated passages which needed either to be removed or recast as factual evidence, as well as passages which I was persuaded were

permissible. But on Day 2 of the trial DB indicated that Mr Tarczynski was not being called to give evidence, and his statement was removed from the trial bundle.

163. Busto asks me to draw negative inferences from the absence of Mr Tarczynski relying on the principles set out in *Prest v Petrodel Resources Ltd* [2013] UKSC 34 (at paragraph 44) and in my own judgments in *FM Capital Partners Ltd v Marino* [2018] EWHC 1768 (Comm) (at paragraph 112); and *Magdeev v Tsvetkov* [2020] EWHC 887 (Comm) (at paragraph 154). In both of those it would be fair to say that I have deprecated the tendency to reflexively ask the Court to draw adverse inferences.

164. This subject has most recently been addressed in *Royal Mail Group v Efobi* [2021] UKSC 33 [2021] 1 WLR 3863. In that case Lord Leggatt indicated at [41] that this area should not be over-formalistic, hinting a step away from the four-stage analysis in *Wisniewski v Central Manchester Health Authority* [1998] PIQR 324:

> "The question whether an adverse inference may be drawn from the absence of a witness is sometimes treated as a matter governed by legal criteria, for which the decision of the Court of Appeal in Wisniewski v Central Manchester Health Authority [1998] PIQR P324 is often cited as authority. Without intending to disparage the sensible statements made in that case, I think there is a risk of making overly legal and technical what really is or ought to be just a matter of ordinary rationality. So far as possible, tribunals should be free to draw, or to decline to draw, inferences from the facts of the case before them using their common sense without the need to consult law books when doing so. Whether any positive significance should be attached to the fact that a person has not given evidence depends entirely on the context and particular circumstances. Relevant considerations will naturally include such matters as whether the witness was available to give evidence, what relevant evidence it is reasonable to expect that the witness would have been able to give, what other relevant evidence there was bearing on the point(s) on which the witness could potentially have given relevant evidence, and the significance of those points in the context of the case as a whole. All these matters are inter-related and how these and any other relevant considerations should be assessed cannot be encapsulated in a set of legal rules."

165. Here it was submitted that if I formed one view of the circumstances in which Mr Tarczynski did not ultimately give evidence (i.e. that he was willing to give evidence but was "*pulled*") I should draw adverse inferences in relation to the areas where his evidence was relied upon. In other words I should infer that the Bank was reluctant for Mr Tarczynski to be cross-examined on (i) the documents that the Bank relies on to establish its change of position defence; and (ii) the way in which the swap had been structured.

166. Interestingly, although at the PTR Mr Tarczynski's evidence was said to go to the change of position defence only, ultimately Busto wished to draw the inference primarily as to other largely unpleaded matters.

167. In the end this point effectively goes nowhere. I cannot say that I found the explanation for Mr Tarczynski's late absence to be completely pellucid, though there was some explanation which was comprehensible. On balance had I had to form a view on this I would have formed the view that evidence of unwillingness was present, and so the premise upon which the inference was to rest was not established.

168. But in any event the occasion for deciding whether to draw an adverse inference does not arise. So far as concerns the change of position defence it will be seen that I do not need any adverse inference to reach a conclusion. So far as unpleaded matters are concerned it cannot be right that the court should draw an adverse inference in relation to these.

169. The keenly fought issue about Mr Tarczynski is therefore a storm in a teacup.

The Issues

170. The following summary of the issues is based on that given by DB in opening and was not controversial.

171. The principal issues which arise for determination at trial are as follows:

i) Given that Italian local public bodies have general civil law capacity, what are the consequences of this for their capacity to enter into contracts under Italian law?

ii) Did the Transactions comply with the requirements of Article 3 of the Decree?

iii) Was Busto's entry into interest rate derivative contracts such as the Transactions subject to any of the following alleged requirements as a matter of Italian law:

a) That the Transactions be for *"hedging"* rather than *"speculation"* (Cattolica Section 8);

b) That a statement of the initial MTM, *"probabilistic scenarios"* and/or *"hidden costs"* of the Transactions be included in the written contracts or in Busto's resolution approving the Transactions (*Cattolica* Section 9); and/or

c) That the Transactions be approved by the City Council (*Cattolica* Section 10).

iv) Are any such requirements properly characterised as a matter of English private international law as limits on Busto's capacity to contract? If not, how are they properly to be characterised as a matter of English law and, as a result of this, to what extent (if at all) is Italian law of any relevance?

v) To the extent that any such requirements are of any relevance to the validity of the Transactions, were they complied with?

vi) If any requirement for City Council approval is properly characterised as an issue of authority (rather than capacity), and this requirement was not complied

with, did Mr Fogliani have ostensible authority to enter into the Transactions and/or were the Transactions ratified by the City Council?

vii) If the Transactions are void:

a) What is the proper law of Busto's claim for restitution?

b) If Busto's claim for restitution is governed by English law, does DB have a limitation defence and/or a change of position defence?

viii) In relation to the alternative claims under Article 1338 of the Italian Civil Code:

a) Is this claim governed by Italian law?

b) If so, is Busto liable to DB under Article 1338 (or vice versa) and, if so, in what amount?

Part 2: The Determinative Issues

172. Although the arguments as to speculation engage the first controversial section of *Cattolica* it is analytically easier to commence with the section 9 issues which engage with the question of general civil law capacity.

Capacity absent Cattolica

173. The position on capacity absent *Cattolica* was not the focus of much debate. For Busto it is *Cattolica* which is the key. However, it is right, before moving onto what *Cattolica* says on this subject, to consider what the position would be absent that decision.

174. The starting point, putting *Cattolica* to one side, is that it is common ground that Italian local authorities have general civil law capacity.

175. The next stage is a consideration of what Article 119 means. Again it is not controversial that this involves a fairly ordinary process of statutory interpretation. As might be expected the Italian Law experts agreed that wording was of primary importance in the absence of ambiguity.

176. Derivative contracts are not explicitly prohibited by this provision; but nor are they explicitly permitted. One then looks to the wording. The wording of Article 119 might fairly be described as permissive: "*shall have financial autonomy ....shall have independent financial resources, ... shall enable Municipalities ... to fully finance the public functions assigned to them… They may resort to indebtedness only for the purpose of financing investment expenditures…*".

177. This wording seems enough to discount one possible argument, namely that Article 119 on its true construction means that derivative contracts are not permitted at all, because the Article does not explicitly allow them. This is equivalent to the way that the House of Lords approached the Local Government Act 1972 in *Hazell*. That conclusion is supported by the fact that Article 41 of the Budget Law of 2002 does explicitly mention "*derivative transactions*" for the first time in the context of the *"public finance coordination framework mentioned in Article 119 of the Constitution".* As Busto

acknowledged in opening, Article 41 is therefore implicit support for the proposition that Article 119 does in some way countenance derivative transactions.

178. Further the reason Mr Fogliani sent the email mentioned at paragraphs 50 and 74 above was that Article 1, paragraph 737 of Law 296/2006, required that proposed derivative contracts be transmitted to the Ministry of Economy and Finance prior to the execution of the contracts. That is only consistent with derivative contracts being permissible – at least to some extent. On any analysis therefore we are not in *Hazell* territory.

179. The only two sub-paragraphs of Article 119 upon which Busto relies in its pleaded case as imposing limits on the capacity of Italian local public bodies to enter into derivative contracts are Article 119(4) and Article 119(6). What is said is that: *"Article 119(4) imposes a requirement of financial balance, and Article 119(6) imposes a requirement that any indebtedness be solely for the purpose of investment expenditure"*.

180. I note here that in terms of the structure of the argument the limitations relied upon appear clearly to refer just to those provisions and the reasoning in the *Cattolica* judgment – hence the centrality of that case to Busto's argument.

181. I should also note that as regards the latter sub-section Busto abandoned its original pleaded case that the transactions involved indebtedness which was not used for investment (contrary to Article 119(6)). By paragraph 5 of its Amended Defence Busto said the following:

> "The speculative and/or aleatory nature of the Transactions ~~as set out in the Transaction Documents was such that the Transactions exposed the Defendant to actual or potential indebtedness within the meaning of Article 119 of the Italian Constitution, and that the Transactions did not involve the funding of investments~~ and/or the fact that the terms of the Transaction Documents do not include any mark to market, probabilistic scenarios or details of hidden costs means that the Transactions did not comply with the limits and constraints on the Defendant's capacity… explained … in the *Cattolica* case" [strike-out and underlining represents amendment]

182. Likewise, at paragraph 38 of its Amended Defence:

> "It is the Defendant's case that the Transactions violate Article 119 of the Italian Constitution ~~on the basis that they entail an actual or potential resort to indebtedness that is not undertaken as a means of funding investment~~s and/or the Italian rules of public finance that are referred to by the Italian Supreme Court at paragraph 8.1 of its judgment in the *Cattolica* case,…"

183. In other words, Busto did originally plead a case that there was a breach on the basis that the Transactions involved indebtedness that was not undertaken as a means of funding investments, but explicitly deleted that to place emphasis instead on the *Cattolica* case. That deletion was never withdrawn and no case on Article 119(6) was

amended back in. It was therefore not open to Busto to advance a case (other than by reference to *Cattolica*) based on that part of Article 119 at trial. Article 119(4) was never specifically invoked. In closing perhaps most focus was put on the (unpleaded) Article 119(2) which is declaratory of local authorities independent financial resources and their role to *"set and apply taxes and revenues of their own, in compliance with the Constitution and according to the principles of coordination of State finances and the tax system"*.

184. But in any event Article 119 was not helpful to Busto. As already noted, neither of these provisions (nor Article 119(2)) refers to derivative contracts, nor do they set out any of the limits on capacity which Busto has pleaded. Busto's case therefore requires words to be read into these provisions. The real means by which this is done is, if at all, via *Cattolica*.

185. Professor della Cananea accepted in cross-examination that Article 119 did not itself impose any limits or prohibition on the use of derivatives by Italian local public bodies and said that *"such a rule may not be laid down by a constitutional provision"*. He also accepted that Article 119(6) is directed at ensuring that Italian local public bodies fund current expenditure from their revenues and that they do not borrow money except for investments and that "*indebtedness*" in Article 119(6) is concerned with how Italian local public bodies fund expenditure.

186. There therefore appears to be nothing in the wording of Article 119 which would put any limits on the use of derivatives.

187. Professor della Cananea suggested that this appearance was deceptive. He argued in his reports and in oral evidence that broadening the view out to take in Article 119(2) and some of the authorities suggested a different reading, and that Italian law therefore recognised limits on the use of derivatives by reference to Article 119. However, I was not persuaded that this reading of these authorities was correct, and Busto did not adopt the argument with any enthusiasm in closing.

188. The first case to which Professor della Cananea referred was Constitutional Court Decision no. 52/2010 – a decision which is also relied on in the context of speculation. He considered that it held that limits on use of derivatives do exist and find their constitutional justification in Article 119(6).

189. That case was concerned (as Professor della Cananea accepted) with the constitutionality of Article 62 of Law no. 112/2008. That is a provision which, after the date of the Transactions, introduced a temporary ban on Italian local public bodies entering into derivatives. I did not find the attempt to rely on this authority convincing. It did not say that there were already legal limits on the autonomy of Italian local public bodies to enter into derivatives under the laws that were in place before Article 62 came into force. In *Cattolica* itself at [7.2] the Court made clear that the judgment was one which dealt with Article 62. While the Court at [8.1] did see Decision no.52/2010 as one which said that the Article 62 prohibition had its roots in Article 119(4) and (6) it did not go further. It did not say that it was reflective of any limitation in Article 119(4) or (6).

190. I agree with the submission that the fact that it was thought necessary to introduce the new laws at all logically suggests that the Constitution did not already impose the limits

that Busto now suggests. Had the prior law not permitted derivatives either there would have been no need for this law, or it would have been couched in different language, as a codification or confirmation of a status quo.

191. Further of course this law has been subsequently amended. At present there is a more nuanced prohibition in force. While Article 119 therefore offers the conceptual basis (or as Professor della Cananea put it: *"the constitutional justification"*) for limitations which have been introduced, those limitations are lines drawn as at those points in time. That is entirely consistent with what the court said in Decision no.52/2010 at [15]:

> "In this respect, it must be noted that the final paragraph of article 119 Constitution places a financial equilibrium restriction consisting in allowing the local authorities to recourse to indebtedness only to finance investment expenditure.
>
> This Court has already clarified that the notions of "indebtedness" and "investment" cannot be determined in an absolutely unequivocal way a priori (decision no. 425 of 2004).
>
> Therefore, it is up to the State, with a clearly not unreasonable statement, to define, in relation to the various contexts that may arise, the meaning of the expressions in question."

192. The second case was Decision no. 70/2012. That case (not referenced in *Cattolica*) was concerned with whether provisions of a 2011 regional budget law (which relied on an expected surplus for a prior year to provide coverage in a later year) complied with Article 81(4) of the Constitution. It was not concerned at all with the ability of Italian local public bodies to enter into derivative contracts. Insofar as it was relied upon to indicate a general scepticism towards contracts with aleatory features that did not really advance the argument.

193. Professor della Cananea also contended that the limits he saw in Article 119 could be found by a combination of Article 119 with Article 81 of the Constitution and/or EU principles. However, this was not a pleaded case and was not cross-examined upon by Busto. It can therefore be ignored. Further, Professor della Cananea's own evidence did not seem to provide much assistance to Busto, accepting that Article 81(4) would be complied with if the law authorising the expenditure gave sufficient indication of how it was to be paid for, and that Article 81(4) does not impose any limits on the types of expenditure that can be incurred. It was therefore hard to discern how these provisions could lead to the limits for which Busto contends.

194. Both of these arguments ultimately appeared to be attempts to find a way around the wording of the legislation which did not otherwise assist Busto. While I would not entirely accept DB's criticisms of Professor della Cananea's approach, it did seem to me that his approach here had a tendency to embrace some fairly extended arguments if they might be seen to support his case.

195. Accordingly, I conclude that Article 119 does not *per se* prohibit Italian local authorities from entering into derivative contracts of a "*speculative nature*".

196. Similar questions were raised in the pleading and opening by reference to the concept of the Transactions being "*aleatory*". Although, particularly in the context of an Italian public authority, it is tempting to find a resonance in this concept, in the end Mr Downes effectively agreed that there was no real difference between the argument that the contracts were speculative, and the argument that they were aleatory. Given the derivation of the word, that makes obvious sense.[3]

197. So far as indebtedness did remain relevant against the background of the deletion of the pleaded case, the obvious source for considering this is Article 3(17) of Law no. 350/2003 which defines indebtedness. One point to note here was that it was quite striking that Professor della Cananea did not cite this source at all in his reports – and also that his evidence was that there was no definition.

198. Dealing first with the question of whether it is a definition, I have no difficulty in concluding that it is. It looks like a definition (both itself, and when looked at in partnership with Article 3(18), which deals with investments). It reads like a definition. What is more there is authority which confirms that that is what it is. Constitutional Court Cases 425/2004 and 52/2010 make this clear. The former for example says *"the very definitions which the State legislature has provided in the contested provisions (Article 3(17), (18) and (19) of Law No. 350 of 2003)…"*. I therefore reject Professor della Cananea's evidence in this regard.

199. The definition in Article 3(17) commences with transactions which are specifically said to be indebtedness (taking out loans, issuing bonds etc). It then goes on to say:

> "Operations that do not involve additional resources, but permit to overcome, within the maximum limit established by current State legislation, a temporary shortage of liquidity and to incur expenses that already have a suitable budget cover, do not constitute indebtedness, pursuant to the aforementioned article 119".

200. On the face of it, this description is apt to cover swaps which restructure borrowing by adjusting the repayment profile. It is notable that the definition of "*indebtedness*" in Article 3(17) was amended, with prospective effect only, from 1 January 2009, so as to include *"premiums received at the conclusion of derivative contracts"*. That focus on the outlawing of the premium implicitly confirms that a "*vanilla*" swap with no premium would not be classified as indebtedness under Article 119(6).

201. Further confirmation of this analysis - if needed - is found in the circular by the Italian Ministry of Economics and Finance dated 22nd June 2007 which states in terms that *"… derivatives are identified, according to the rules mentioned above, as "debt management instruments and not as indebtedness"."*

202. It is fair to say that Busto did not really grapple with this provision (Article 3(17)). I consider that it is significant and that to the extent that a case on indebtedness could be

[3] Caesar's attributed famous bon mot on crossing the Rubicon *"iacta est alea"* is most often translated as *"the die is cast"*. (The passage in Suetonius, De vita Caesarum, lib I, xxxii and less famously Plutarch, Moralia 206.7; Caes. 32; Pomp. 60 draws on an earlier phrase from Menander Fragment 65). The common translation glosses the fact that alea is a word which can cover the game of dice or any game of chance.

said to survive (contrary to what I have said above) it is effectively concluded, against Busto, by this provision.

203. The result is that approaching the question simply as a matter of statutory interpretation, there is nothing in Article 119 which appears to give rise to any limitation in the capacity of Italian local authorities to enter into derivatives transactions. Absent *Cattolica,* the conclusion would be straightforward:

i) The Transactions were not "*indebtedness*" and they fell outside the scope of Article 119(6);

ii) Article 119(6) is not a limit on capacity.

204. DB essentially submitted that this was the end of the point, in that legislation is the primary source of law, and Italy as a civil law system is not precedential. I do not accept that submission. The analysis of the legislation forms the backdrop to the analysis of *Cattolica*. It has weight. However, as I have already made clear, I do consider that some considerable weight has to be given to the decision of a court comprising joint divisions of the Italian Supreme Court which so sat apparently in order to assist in resolving uncertainty. It might be the case that in some circumstances it offers a less than safe guide to what an Italian Court hearing the issues in this case would do, or what it would do in another case raising the same issues. But *prima facie*, as Professor Perrone agreed, one would expect it to be given considerable, or even particular weight by Italian Courts.

205. It is therefore necessary to move into *Cattolica* and see what it says about the Article 119 issues.

Capacity and Section 9 of Cattolica

206. One issue to which *Cattolica* is central is the question of whether Section 9 of *Cattolica* is concerned with the capacity of Italian local public bodies to enter into derivative contracts or, as DB says, is concerned with the requirements of a valid contract under Article 1325; Article 1343; Article 1346 and Article 1418.2 of the Italian Civil Code that it must have a determined or determinable object ("*oggeto*") and a valid/lawful "*causa*" and the disclosure requirements that exist under Italian civil law. It was this debate which underpinned the differing approaches of the parties to expert evidence, with DB putting this question in the hands of Professor Perrone and Busto in the hands of Professor della Cananea.

207. Busto's position - by reference to the wording *"However, that does not fully solve the problem brought to the attention of these Joint Divisions, since we must – within the ambit of the path theoretically admissible – determine whether other limits exist on the lawfulness of those contractual types for the Public Administration"* - is that Section 9 of *Cattolica* is at least in significant part concerned with the capacity of local authorities to enter derivatives contracts. This is quite clear at [74] of Professor della Cananea's first report where he says that he has *"no hesitation"* in saying this. He says that there is a caesura between the civil law aspects and those dealing with administrative law and public finance.

208. Specifically, he says that Section 9 of the judgment imposes further limits on the contractual power of a local authority beyond the requirement that the derivative be financially cost effective/non-speculative set out in Section 8 of the judgment. Busto sees the Supreme Court's analysis up to and including paragraph 9.8 as directed towards grounds 3, 4 and 5 of BNL's grounds of appeal looking at the civil law aspects through the perspective of the rules of public finance. Thus, Professor della Cananea says one sees the threads of this analysis are being brought together by the Supreme Court in paragraph 9.8 of the judgment where grounds 3, 4 and 5 are dismissed.

209. In closing Mr Downes emphasised the need to focus on paragraph 9.8 of *Cattolica*, which he submitted was not really susceptible of being read as going to civil law issues rather than capacity; and the support which is found for Busto's approach in the official *Massima Ufficiale* [official maxim] that was published by the Italian Supreme Court in order to explain the decision in *Cattolica*.

210. He emphasised that the importing of concepts from public law into private law (and *vice versa*) is not unheard of in this jurisdiction. For example, in *Braganza v BP Shipping Ltd* [2015] UKSC 12 (a case concerning the limits on the exercise of a contractual discretion), the law of contract can be seen to be borrowing from public law, e.g. in relation to a requirement that the discretion not be exercised in a way that is *Wednesbury* unreasonable. He also contended that the approach of DB rendered it necessary to read down or reject large parts of the rest of the *Cattolica* decision.

Discussion

211. I conclude by a clear margin that this section is not concerned with capacity and that despite the clarity and force with which Busto's arguments were presented, DB's arguments are to be preferred.

212. The starting point is that Section 9 of the *Cattolica* decision is not concerned with either of the issues specifically referred to the court. Those questions were, as noted above:

> "a) "whether the swap, particularly the swap that included an upfront …. constitutes, for the local entity, a transaction that results in indebtedness to finance non-investment expenditures pursuant to Article 30, paragraph 15 of Italian Law No. 289 of 2002"; and b) "whether the execution of the related contract falls within the authority reserved for the City Council, since it entails an expenditure decision that affects budgets for subsequent financial years, pursuant to Article 42, paragraph 2, letter i) of the T.U.E.L."."

213. It is clear – indeed it is common ground between Professor Perrone and Professor della Cananea - that in the *Cattolica* case the Supreme Court *"considerably expanded the perimeter of the appeal brought before them"*. One therefore has to have careful regard to what exactly the Court was deciding and upon what it was effectively commenting.

214. It is therefore important to track through what the Court is doing at particular places in the judgment. It is clear that the capacity limits which the Supreme Court considered to apply to the execution of derivative contracts by local public bodies specifically are directly addressed in sections 7 and 8. Each section starts with a wording which makes

this very clear. Section 7 starts with this introduction: *"... we can proceed with examining the issue ... relating to the execution of derivatives, swaps and IRSs by public entities in general and local entities in particular*". Section 8 starts by noting that *"the contractual power of local entities had clear limitations"*. That then leads to its "*first conclusion*" on speculation, which I address below.

215. One therefore needs to have clear focus both on the start of section 9 and how it proceeds. Section 9 starts with the following introduction: *"However, that does not fully solve the problem ..., since we must – within the ambit of the path theoretically admissible – determine whether other limits exist on the lawfulness of those contractual types, for the Public Administration"*. There was considerable evidence directed to the question of what was meant by *"other limits"* as well as to the wording *"the ambit of the path theoretically admissible"*.

216. As a matter of simple language, *"other limits"* at least suggests that something qualitatively different is being considered – though it gives no hint as to what those different limits are. While there was a difference of opinion on this, with Professor della Cananea saying that *"a literal and systemic reading of 9 shows that the court is still in the realm of capacity. They have not moved to other issues, and that is confirmed by paragraph 9.8.", I* found the evidence of Professor Perrone on this to be more robust.

217. In particular:

i) Professor Perrone's evidence appeared to regard the relevant section of the judgment overall, as well as microscopically;

ii) His analysis in his report was clearly reasoned;

iii) In contrast Professor della Cananea's evidence appeared to have a tendency to seize on a small passage without regard for the surrounding, and then (see above as regards the statutory interpretation arguments) to seize on other matters whose relation to the argument were not clear to support it.

218. And indeed, in cross-examination Professor della Cananea accepted that *"They are making a point that even within hedging derivatives there are certain requisites which must be respected"*. In other words, he recognised that this section deals with the civil law requirements as they apply to swaps. That conclusion sits perfectly within the framework of a logical reading of the bridge between paragraphs 8.3 and 9: paragraph 8.3 terminates with a conclusion about capacity ("*only in the first case could a local entity be said to have capacity to enter into them*"); that then leads into the wording at the start of section 9 which identifies the need to determine whether *"other limits"* exist – that itself strongly suggests the limits being considered are qualitatively different to the issue of capacity.

219. The next assistance, which dovetails with these points, is given by the next paragraph of the decision, paragraph 9.1. That states: *"There is still no solution for the general problems relating to the definiteness (or determinability) of the object [oggetto] of the contract."* This terminology seems to be a clear indicator that what is being considered is a question of validity under the general civil law. This is because there is, pursuant to Articles 1325, 1346 and Article 1418 of the Civil Code a requirement for a determined or determinable object ("*oggetto*") as a pre-requisite for the validity of any

contract under Italian law, regardless of whether the contracting parties are public or private bodies. The reference to "*oggetto*" is not casual or passing: there are further references in paragraph 9.2 and in paragraph 9.8.

220. The question then becomes whether the provisional indication that the Court is considering general civil law issues in this passage is one which makes sense, both in terms of what is said, and in terms of such an issue being one of relevance to a contract of this sort and issues such as the ones arising in this case. That is because if a reference to civil law validity questions were nonsensical in either context that would obviously indicate that that was not what the Court was doing at this point.

221. A reading of the judgment, and a consideration of the expert evidence, makes quite clear that such an approach is not nonsensical at all.

222. As for the reading of the judgment, it makes perfect sense in the context of a civil law issue. As a matter of Italian civil law, a contract has to have a cause ("*causa*") and an object ("*oggetto*"). One can readily see that questions might arise as regards swaps contracts viewed through this lens. How one defines the object of the contract will have a knock-on effect on the other components of the analysis and the result. What the judgment on its face is doing here is to consider these points, concluding that the object of a derivative contract is *"the degree of uncertainty [alea]"* and that a contract will not fulfil the civil law oggetto requirement, unless the risks can be "*precisely determined*" by the parties.

223. Furthermore in circumstances where the derivative contracts in *Cattolica* were governed by Italian law, it is only natural that Italian civil law requirements for a valid contract would be considered in that case.

224. All of this is the more so given the juridical backdrop to *Cattolica*. In 2013 the Court of Appeal of Milan in decision no. 3459/2013 ("*Gommeservice*"), a case involving a derivative contract entered into by a small private firm, considered the question of civil law requirements in that specific context. It did not raise any issue of capacity. In so doing it considered an academic article by an Italian contract law scholar, Professor Maffeis, which focussed on the requirements for derivative contracts to be valid under Italian contract law. Professor Maffeis' paper was not concerned with derivatives entered into by Italian local public bodies. The *Gommeservice* decision was published in late September 2013 – hence after *Cattolica* at first instance.

225. However, after the decision in *Gommeservice*, the civil law requirements of a valid derivative contract were heavily debated amongst Italian legal scholars and in the case law, as explained by Prof. Perrone. The reasons for the controversy were because it had been widely accepted by Italian legal commentators and case law that derivative contracts are not properly to be characterised as being analogous to wagers, which is the starting point of what is known as *"the rational bet theory"*.

226. The *Gommeservice* decision was then referred to in passing in the decision of the Court of Appeal of Bologna in its decision in *Cattolica*.

> "We also briefly note that none of the contracts include the determination of their current value at the time of stipulation (the "mark to market"), which careful, consolidated case-law on the

> merits (see [*Gommeservice*]) considers to be an essential element thereof and which forms part of its standard cause (a rational reasoning and which can therefore be measured), which must be specified, …"

227. The passage is brief but plainly deals with cause/causa – and hence civil law requirements. It was not stated to be related in any way to the issues of administrative law that were considered elsewhere in the judgment.

228. It was common ground that at paragraph 9.7 of the *Cattolica* decision the court is reflecting the approach of the Court of Appeal of Bologna in *Cattolica*.

229. One can therefore trace the arguments of civil law through in the background to *Cattolica* in the Supreme Court; and given the debate which I have noted it would make perfect sense for the Supreme Court to deal with that issue.

230. The conclusion that they did so seems to me relatively clear; not simply because of the explicit reference to oggetto and the juridical pedigree of that reference but in particular because Professor Maffeis' analysis is manifest. If one compares the relevant passage in his article to the relevant section in the *Cattolica* judgment, one finds this:

Cattolica paragraph 9.1	**Maffeis p 5**
the validity of the agreement must be examined in the presence of a contract [...] that sets forth (or does not) **the measure of the degree of uncertainty [alea], calculated using recognised and objectively acceptable criteria**	[T]he conditions under which the derivative contract is, in my opinion, lawful, are mainly represented by the agreement between the intermediary and the investor on **the measure of the degree of uncertainty [alea], calculated using recognised and objectively acceptable criteria**
[T]he law authorises only **this type of bet** based on the presumption **of the social utility of rational bets**, understood as an evolved type of **the bets of mere ability**	[T]he rationale for the legal authorisation of **this type of bet** is the recognition by the law, of **the social utility of rational bets** as a type of the ancient genre **of the bets of mere ability**

231. In other words, the Supreme Court reproduce and *precis* sections of an article which is avowedly (and probably to its main audience very recognisably) dealing with issues of civil law validity - albeit in the specific context of derivative contracts.

232. There are also, as DB noted in closing, telling echoes of the earlier section of the judgment which itself picked up the wording as to social utility, and then added to it a passage referencing Article 23 paragraph 5 of Law no 58/1998 (the Consolidated Law on Finance, or TUF) which considers the function/purpose [causa] of a swap.

233. Further when looking at this section of the judgment it is very noticeable that Section 9 of the *Cattolica* decision does not contain the word capacity ("*capacità*") which appears in section 8. It also refers generally to the position of the "*investor*" or the "*client*", rather than making specific reference to contracts entered into with Italian public bodies.

234. There was nothing in the expert evidence which impacted on this analysis. The thrust of Professor della Cananea's argument was to contend that somehow there was a subtext or continuing theme of public finance which was transformational. However, I did not find that argument compelling. While Professor Perrone did accept that this section is grounded in rules of public finance, he was quite clear that what was being considered were civil law issues; so civil law issues - but in the context of a public law situation. While Professor della Cananea attempted to maintain that paragraphs 8.3 and 9.8 indicated that the section was about capacity he did (as noted above) accept that general requirements were considered, and later in his evidence he suggested that:

> "In 9 they explained why they need to consider further limits. In the paragraphs which you have just mentioned, and I totally agree with you, 9.1 until 9.6 or 9.7 they return to the general analysis concerning all parties and then they go back to public authorities in 9.8.
>
> …the court is … at the same time is using two levels of analysis, a more general one concerning all parties, and a more specific one concerning local authorities. And that is made evident…"

235. However, there was no real attempt to explain how these two strands synthesised together. It is no answer to suggest (as Busto did) by reference to *Braganza* that in this jurisdiction in a particular context there has been a cross fertilisation of ideas. *Braganza* concerned a different jurisdiction, and a specific context where it is easy to see why the test from another area of law has something to contribute. The fact that this was suggested as a possibility by Foxton J in argument at the stage of settling the expert disciplines can add nothing at the close of the present case; what is lacking is any real case as to how this cross fertilisation is said to work in the context of *Cattolica*.

236. This brings one to paragraph 9.8 which Mr Downes submitted has to be read in a closely textual way and in isolation:

> "It's always useful for the starting point is: well, what do the words mean in isolation? If they have the meaning for which you contend in isolation you don't need to look elsewhere in the document. And if they don't have the meaning that they have it said in isolation, then one has to look for compelling reasons elsewhere in the document. … in isolation those words mean that. And the rest of the document doesn't help because the rest of the document is consistent with either reading. So we are left on English usage clearly in favour of our construction."

237. Skilfully as this argument was made, both in cross-examination and submissions, it did not persuade me. The bottom line is that both parties struggle to fit paragraph 9.8 perfectly into their arguments. Both parties wanted to make "*adjustments*" to the drafting to reflect more perfectly what they said was the right reading. Mr Downes in his cross-examination of Professor Perrone wanted to make some fairly significant changes to the punctuation. Professor Perrone for his part said that he thought the actual drafting did not make sense (at least in the English translation from which we were all working). The respective approaches can be seen below:

238. Mr Downes' reworking of the paragraph (original at paragraph 145 above) went like this:

> "9.8. — Based on that analysis, …we must confirm the rule of law as follows:
>
> In regard to derivative contracts entered into by Italian Municipalities based on**: (i)** the laws in effect until 2013 (when Italian Law No. 147 of 2013 precluded any further use of them)**;** and **(ii)** the distinction between hedging and speculative derivatives, based on the criterion of the different degree of risk of each of them~~,~~ **:**
>
> **A**lthough local entities could enter into the former with qualified financial intermediaries, local entities could usefully and effectively do so only if the contractual object [oggetto] could be precisely measured/determined, including the mark to market criterion, probabilistic scenarios and the "hidden costs". ….."

239. Professor Perrone's reworking was this:

> "9.8. — Based on that analysis, …we must confirm the rule of law as follows:
>
> In regard to derivative contracts entered into by Italian Municipalities based on the laws in effect until 2013 **[**(when Italian Law No. 147 of 2013 precluded any further use of them) and the distinction between hedging and speculative derivatives, based on the criterion of the different degree of risk of each of them**]**, although local entities could enter into the former with qualified financial intermediaries, local entities could usefully and effectively do so only if the contractual object [oggetto] ~~**could**~~ **should** be precisely measured/determined, including the mark to market criterion, probabilistic scenarios and the "hidden costs". …."

240. Ultimately, I felt that Professor Perrone's approach appeared to be more consistent with the text and with the structure of the judgment.

241. Secondly Busto's approach seemed to place far too much weight on the words *"based on"* (the second *"based on"*, in the larger section of text) which it was said can only be read as reflecting a conclusion drawn by the Court from the two premises that are then

sought to be broken out from the paragraph. I have no difficulty in accepting the submission that they can at least equally well be said to be reiterating why the Supreme Court had concluded, in section 8 of the judgment, that Italian local public bodies could only enter into hedging (and not speculative) derivative contracts.

242. The result however is that I do not accept Mr Downes' submission that his reading of the words is the true literal reading.

243. Nor did this approach pay due respect to the careful structure of the *Cattolica* judgment or the evidence of Professor della Cananea. As to the former I have already noted the apparent scheme of the judgment – to break the text into themes. It instinctively seems illegitimate to read a single paragraph rounding off a prior section in isolation. That instinctive approach is (predictably) reflected in Italian law which, as Professor Perrone said, requires the text of judicial decisions to be read as a whole and in context. Further even within this section, paragraph 9.8 is drafted as referable to the prior passages of that section, because 9.8 starts thus: *"based on that analysis"*. Therefore, one has to expect to see within 9.8 something which bears relation to what is discussed in 9.1-9.7; on Busto's case 9.8 does not take anything from those passages. They are, in effect, to be treated as surplusage. That is inherently unlikely in a considered judgment of the joint divisions of the Supreme Court.

244. In reality the exercise of construction works far better and more cohesively if one sees paragraphs 9.1 and 9.7 as setting out the premise for paragraph 9.8; this reflects the first *"Based on that analysis .."*. The rule then follows from the words *"although local authorities could…"*; and it is a rule which relates to civil law requirements.

245. There would also be an anomaly in 9.8 if Busto were right; that is that the basis of consideration of such matters as MTM and probabilistic scenarios has no context in the cases on capacity; it would simply make no sense to interpolate them if the consideration was one of capacity. It would, in effect, be adding apples into a bowl of oranges.

246. As to Professor della Cananea's evidence, he explicitly accepted in cross-examination that:

    i) Paragraphs 9.1 to 9.6 are dealing with questions of validity as regards derivatives;

    ii) Nowhere in 9.1 to 9.7 is it suggested that this analysis is limited by specific rules relevant to public administration;

    iii) That reasoning is also relevant to private bodies;

    iv) Paragraph 9.8 does not mention capacity.

247. One other point with which I should deal is the submission that the last sentence of paragraph 9.8 makes no sense if DB is right. That sentence is:

> "This is to reduce to a minimum and make the entity aware of all of the aleatory aspects of the contract, since they are highly inconsistent with the rules relating to public finance and they

> introduce variables that are not compatible with the fixed nature of expenditure commitments shown in the financial statements."

248. Professor Perrone accepted that this sentence was problematic on his reading. He also suggested that it was an odd sentence if one accepts that the Court is saying that such contracts can only be entered into if they are hedging. However even accepting that problem, I cannot see that as sufficient to tilt the argument back. The answer on what this section is doing seems clear. The analysis is founded in the structure and the part of the paragraph which purports to be laying down the rule. To reach an opposite conclusion based on this would be the tail wagging the dog.

249. Further it might well be said (as Professor Perrone effectively did) that this is a not entirely happily expressed combination of an explanation of the reason for the fact that on top of the capacity limits there are also civil law limits – and how those limits interact with the capacity rules.

250. As for the *massima ufficiale* I cannot accept (and it was not really put so high) that this could stand against the weight of this analysis. The *massima* is itself somewhat ambiguous, with its heading referring to the requirements or elements for a contract and the summary referencing the object/oggetto. Further these summaries have no precedential value, and Professor Perrone's clear evidence that their use is (very/quite) controversial was not challenged.

251. Ultimately, I conclude that Busto's interpretation of section 9 of the *Cattolica* decision as being concerned with capacity does not sit well with the wording of the judgment, or with the juridical derivation of that section. It depends upon reading the section as being somewhat jumbled (interpolating general requirements which go nowhere) against a background where one can see from the summary of the judgment given above, some considerable trouble has been gone to by the court to set out a clear structure with each section dealing with a distinct point or issue. Further, it is also inconsistent with the general principles of Italian law relating to the capacity of Italian public bodies which have general civil law capacity, given that one would expect any limit on the capacity to be carefully identified by the Supreme Court and discussed in the context of that general civil law capacity.

The post-Cattolica cases

252. To the extent that it is necessary to do so, I do also conclude that further support for this analysis can be found in the decisions of lower courts since the decision of the Supreme Court in *Cattolica*.

253. It was submitted for Busto that the only cases that are of any real assistance to the court are cases involving swap transactions entered into by Italian local authorities. But this is arguing from the assumption that Busto is correct. To test the parties' approaches it must be right to look more broadly. It would naturally be of great interest if (as is agreed not to be the case) there was a local authority case where swaps were not upheld on the ground of capacity, citing paragraph 9.8 of *Cattolica*. But it is also of interest, and logically of relevance, if that passage of the judgment has been considered to be relevant outside the world of local authority transactions.

254. Nor do I consider that, in the context of the very specific issues in this case, one can take anything of note from the fact that there is no post-*Cattolica* case involving an Italian local authority in which the swap transactions have actually been upheld.

255. Professor Perrone identified eight decisions in which section 9 of the *Cattolica* decision has been applied and opined that the court in each of them treated the issue as going to the general civil law requirements for a valid contract - the causa and oggetto aspects - and not as raising any issue of capacity of local public bodies. Not all of these were the subject of detailed evidence, but it is worth dealing briefly with the ones which were discussed in depth.

256. The decision of the Tribunal of Pavia dated 16 September 2020 is now not particularly controversial. It concerned derivative contracts between the Province of Pavia and Intesa SanPaolo. The court in that case referred to *"the ongoing debate in academic legal circles and in the courts ... about whether MTM is an essential element of the contract"*. It also referred to the *Gommeservice* decision. The court then specifically relied on the *Cattolica* decision as a reason for adopting the approach in *Gommeservice* in relation to the civil law requirements for a valid contract. The Court does not mention any limits on the public body's capacity in the judgment. Busto accepts that the court declares the invalidity of the swap on the basis of principles of Italian contract law.

257. Although there is reference to paragraph 9.8 of *Cattolica* it seemed to me on following the evidence, and again on reverting to the decisions after the close of the case, that the flavour of the case is very much one concerned with the civil law requirements, that it approached paragraph 9.8 in line with my conclusions above – in other words as expressing a conclusion on civil law requirements (albeit in the particular context) and that its conclusion flows from its consideration of the civil law issues. Professor della Cananea himself accepted in his evidence that the decision deals with civil law requirements for a valid contract.

258. The other authority to which much reference was made was the decision of the Court of Appeal of L'Aquila which refers to both causa and oggetto and to the contracts being void under Article 1418(2) of the Civil Code. There is at the same time reference to the local authority's status, in that having noted the Supreme Court's requirement that mark to market, probabilistic scenarios and hidden costs be provided, the Court of Appeal observed that *"[t]hese parameters have to be complied with all the more when a swap is entered into by a local authority, which under the regulations as recalled above, until 2013 could enter into Interest Rate Swap contracts, providing they were hedging and never speculative derivatives, thus with the purpose of hedging bond loans or debts"*. But that wording *"all the more"* is, as Professor Perrone noted, a giveaway that what is being considered is something not confined to local authorities; hence it is the civil law question of validity.

259. A similar approach can be seen in decision no. 24/2021 of the Court of Appeal of Ancona. That was a case involving a private company, but the Court referred to the *Cattolica* decision and stated (at [4]):

> "Nor can it be argued that the significance of this decision is limited to the public administration sector when it deals with derivatives. All commentators argued for the general scope of many of the statements contained in the aforementioned

> decision, which, moreover, already qualifies as such on a first reading."

260. Professor della Cananea saw the decisions in these cases very much through the prism of his own reading of *Cattolica*, with considerable focus on paragraph 9.8 of that decision. However, his reasoning was at times hard to follow, since at the same time he did accept – as on the wording of those decisions he had to - that the reasoning dealt with the civil law requirements for a contract. It was also not clear why, if he were correct as to his approach to *Cattolica*, the Ancona court (dealing with a dispute with a private company) should consider the decision in *Cattolica*. He accepted that this court's decision effectively says that section 9 of *Cattolica* is not limited to public bodies.

261. The Tribunal of Milan in its decision of 4 May 2021 seems to interpret *Cattolica* as being a public finance case. However, it is clear that it was not argued in that case that the swaps were null and void and consequently the decision is of little relevance in the present context.

262. Although I give no weight to the academic commentaries in reaching my decision (since they can plainly have no precedential value and time constraints meant that they were not the subject of cross-examination) I gain some encouragement from the fact that it seems that the most dominant academic approach to section 9 of the *Cattolica* decision is in line with that conclusion. DB referred me to articles by Calabrese, Natoli, Poli, Cusomano and Tucci. Busto sought to strike back by reference to some articles co-authored by Professor Perrone and Mr Danusso. I did not find these articles particularly easy to follow. On the whole I would tend to accept the submission that while deprecating the approach of the court generally, so far as regards section 9 they suggest that the decision is potentially of broader application. Thus Professor Perrone refers to the possibility that the decision might *"retroactively affect any derivatives entered into, at any time, by both financial and non-financial entities"*, while Mr Danusso refers to the case applying *"private law requirements"*. However (i) this approach appears to be a discussion point (the dangers of *Cattolica* if given a broad reading) and (ii) this approach is not that of the academic majority.

263. The conclusion that section 9 of the *Cattolica* decision is concerned with the elements of a valid contract under Italian civil law, not the capacity of Italian local public bodies, is highly significant in the context of this dispute. This is because if the question is one of material validity, not capacity, the question of the proper law of the contracts becomes relevant. The Transactions are expressly governed by English law. The material validity of the Transactions is therefore to be determined under English law. It follows that any requirements as to material validity set out by the Court in *Cattolica* (in relation to contracts governed by Italian law) are inapplicable to the Transactions.

264. I should deal briefly with Busto's backup case, which was to say that if it is not clear that paragraph 9.8 of *Cattolica* is concerned with the capacity of an Italian local public body, then it is at least possible to read paragraph 9.8 of *Cattolica* in this way and that it is highly unlikely that the Italian courts would read down *Cattolica,* thereby opening the way for Italian local authorities to circumvent these same rules by simply choosing foreign law. The answer to this is that it is not a question of reading down but of correct interpretation and I conclude that DB's is the correct interpretation by a clear margin. Accordingly this backup case does not arise.

265. It follows that Busto's defence based on section 9 of *Cattolica* fails.

Formal requirements

266. For completeness however (and while it is strictly speaking contingent) I should deal here with the substance of that defence. Had I concluded otherwise as to the nature of the issue, such that the requirements in section 9 had to be considered, I would have concluded that the Court did not lay down any hard and fast rule.

267. The emphasis here is on the apparent dichotomy between the fact that the Supreme Court suggested that on the facts of the *Cattolica* this would require the parties to be aware of *"the mark to market criterion, probabilistic scenarios and the "hidden costs""* and its emphasis elsewhere on the "*case by case*" approach which would only make sense if there were no hard and fast rule. In my judgment this is what the Court was really saying: the ultimate objective is to enable the counterparty to make an informed assessment of risk. This is what underpins some quite detailed discussion of the different types of swaps at Part 4, and an analogy to consumer investment transactions at [9.4-5] which would not be applicable to all swap transactions. It also reflects the fact that the question of mark to market is first raised at [4.7] in relation to the consideration of "*non-par*" swaps in which an upfront is paid (as it was in two out of the three swaps in *Cattolica*). I therefore conclude that the rule is stated in 9.7 when the court says clearly that the analysis must be determined *"on a case-by-case basis, using a practical approach"*.

268. That approach makes perfect sense since it is a question of fact whether the parties to a contract are able to make an informed assessment of risk and what information they require to carry out that assessment. Further, were Busto correct and all of (i) MTM; (ii) probabilistic scenarios and (iii) hidden costs required to form part of the transaction documents in all cases this would be a surprisingly formalistic, inefficient and impractical position. The unattractiveness of that submission was underlined by Professor della Cananea's evidence that an Italian local public body could not even be expected to be aware of this requirement.

269. In this case I conclude that, were it relevant, Busto was in a position to make an informed assessment of risk and had available the information required to carry out that assessment. The first point is that the transaction was not particularly complicated:

i) The Mirror Swap cancelled out the effect of the 2002 Swap and entirely removed Busto's exposure to the risks of rising interest rates above the threshold in the 2002 Swap. It did not present risks for Busto in any meaningful sense;

ii) The principal exchange element of the Cash Flow Swap was also essentially straightforward and risk free. Busto simply received fixed principal exchange amounts from DB from 2007 to 2013 and paid the same amount to DB from 2014 to 2031. This was easy to comprehend and did not involve any uncertainty from Busto's perspective as to cash flows;

iii) The risks of the interest collar element of the Cash Flow Swap were the most complex – but still essentially elementary. They were clear and straightforward for Busto to evaluate and understand. It was explained to Busto that its interest costs would only vary within the maximum rate of the cap and the minimum

rate of the floor. Thus, if interest rates fell below the floor rate, Busto would not benefit. This was obvious.

270. Secondly, these indications are supported by a consideration of the material which Busto had available to it. The simulations sent by DB to Busto on 29 June and 5 July 2007 provided Busto with the forward rates on each payment date through to 2031, and projections of the cost of the proposed revised principal repayment profile based on the forward curve, bearing in mind the collar structure of the Cash Flow Swap. DB also informed Busto in the Term Sheet that the initial MTM of the Cash Flow Swap was positive to DB and therefore negative to Busto.

271. Thirdly Busto had the time and resources to make an informed decision. The timeline demonstrates that there was ample time, there was lots of negotiation and Busto had its own well qualified expert committee. Here it is worth bearing in mind that the reports of the *Cattolica* case do not make it clear what was sent - or whether that was a case where the bank was dealing with a professional investor. The consumer legislation quoted in that case tends to suggest it was not.

272. Fourthly, this was not Busto's first experience of swaps – it had prior experience of the swaps market via the 2002 Swap and Busto was classified as a qualified investor.

273. Finally, though perhaps strictly speaking irrelevant for the purposes of deciding whether Busto had the material available to enable it to make an informed assessment of risk, the evidence shows Busto doing just that:

i) City Board resolution no. 417/2007 stated that *"the interest rate [would be] parameterised at the Euribor rate inserted within a maximum and minimum oscillation corridor"* under the Cash Flow Swap;

ii) It was clear from her evidence that Ms Marino fully understood how DB's proposals worked and in particular that, under the Cash Flow Swap, the minimum rate that Busto would pay was the floor rate and it would not benefit if interest rates fell lower;

iii) Ms Marino's evidence was also that that she understood that the forward projections showed a comparison of the expected cost to Busto of its existing borrowing and on the basis of a re-profiling of its principal repayment profile and an interest rate collar with assumed floor and cap rates;

iv) Professor Zucchetti and Ms Criscuolo (the external members of the Expert Committee with specialist expertise in relation to derivatives) explained each of the banks' proposals and their analysis to Ms Marino and Mr Fogliani;

v) It was also Ms Marino's evidence that the Expert Committee as a whole (including Ms Marino) discussed the merits of each proposal;

vi) Ms Marino also said that she and Mr Fogliani would have taken the opportunity to ask Professor Zucchetti and Ms Criscuolo about anything she did not understand. She accepted that she would not have signed the Expert Committee's report unless she understood and agreed with it;

vii) The Expert Committee's report (which was annexed to City Board resolution no. 398/2007):

a) Described the economic effects of DB's proposal in some detail;

b) Specifically identified that the floor rate was *"rather high"* relative to the forward curve - and Busto successfully negotiated a reduction in the floor rate with DB as a result;

c) Confirms that Busto fully understood DB's proposals and formed the view (based on the analysis of Professor Zucchetti and Ms Criscuolo) that the DB proposal was the most advantageous which Busto had received.

274. In those circumstances, I conclude that Busto was able to make an informed assessment of risk, and had the information required to carry out that assessment. To the extent that it is relevant I would also conclude that it carefully made an informed assessment of the risk.

Cattolica and Speculation

Section 8, speculation and capacity

275. The second set of questions to which the *Cattolica* decision is relevant is that of whether Busto lacked the capacity to enter into speculative transactions. Professor della Cananea's opinion is that at the relevant time Italian local authorities were not permitted to enter into derivatives contracts which were speculative in nature.

276. DB implicitly accepted that *Cattolica* was difficult for it on the law here, though it pointed out a number of what it regards as infelicities in that judgment. For example it noted that the Court in *Cattolica* identifies no express prohibition, nor any other basis in law, for this conclusion, does not attempt to define what is meant by "*speculation*" in this context or offer guidance as to how the characteristics of a "*speculative*" contract might be identified: it is simply asserted that a distinction is to be drawn *"based on the criterion of the different degree of risk"*.

277. Ultimately it seems to me that what the Supreme Court says in this regard is clear. At paragraph 8.3 it says in terms:

> "Hence, in light of the legal and axiological framework outlined above, we can arrive at a first conclusion, namely: Recognition of the Administration's capacity to conclude derivative contracts, based on the law in effect until 2013 (when Italian Law No. 147 of 2013 precluded that possibility) and the distinction between hedging and speculative derivatives, based on the criterion of the different degree of risk of each of them, meant that only in the first could a local entity be said to have capacity to enter into them"

278. Whether that conclusion is correct or not is not in my view a matter for this Court. I accept this paragraph *dubitante*. I have expressed above a view on case 52/2010 which

might be said to sit ill with the summary given by the Court in the *Cattolica* judgment. There is no clear consideration in *Cattolica* of how the general civil law capacity of local authorities impacts on the analysis. I would also tend to accept the argument that the assertion in paragraph 8 that the changes in the law set out in section 7 *"make it possible to conclude"* that *"the contractual power of local entities had clear limitations"* is rather hard to follow. The "*difficult*" sentence at the tail of paragraph 9.8 ironically also to some extent suggests that the Court did not regard itself as having set down a rule on speculation.

279. However while these points may well be the subject of argument in future before the Italian Courts, as matters stand it seems to me that the Supreme Court has spoken on this point; and that regardless of the fact that there is no doctrine of precedent other courts are - at least in the medium term while debate works itself out - likely to feel themselves constrained by the clarity of the wording by the country's most senior court.

280. I therefore conclude that as these matters stand, as a matter of Italian Law local authorities may only enter into derivatives contracts if they are for hedging – and not if they are speculative.

Are these contracts speculative?

281. This point became highly contentious in closing, with arguments about the burden of proof and whether aspects of the case sought to be advanced by Busto were properly in play.

282. The case as pleaded was this: that the speculative and/or aleatory nature of the Transactions meant that the Transactions did not comply with the limits or constraints explained in *Cattolica* on Busto's capacity to enter into such transactions. In the Further Information this was particularised thus:

> "The Transactions were speculative in that they involved the purchase of a financial instrument (viz the swaps) at an implied cost referable to the mark to market value at the time of acquisition. In relation to the interest rate aspect of the instruments, their value lay in the hope that they would turn out to have been worthwhile. In that sense they were speculative.
>
> In the premises the future value of the swap instruments was entirely dependent on uncertain future market movements."

283. This was met by a plea denying that the Transactions were speculative and asserting that they were *"entered into for the purposes of hedging the Defendant's liability under existing indebtedness and thereby managing the costs of the Defendant's borrowing"*. This plea was advanced by reference to the City Board decision number 398 of 10 July 2017. In other words, DB said: *"No, the Board says it is for hedging"*.

284. No rejoinder followed to this plea. In the List of Common Ground and Issues the focus was firmly on the issues of Italian law; the factual aspects of those issues were dealt with in very broad terms at Issues 4 and 5: did the Transactions comply with any

requirements of Article 119 that applied to them, if not in what respects and what are the legal consequences? There was no suggestion that financial experts were necessary.

285. The pleading as to "*speculativeness*" was therefore broad and elementary. The pleading does not identify any features of the cash flow swap which were said to make the transaction speculative. In particular it does not plead that a negative MTM would make the borrowing speculative; MTM was identified only as going to the informed decision aspects, in partnership with probabilistic scenarios and hidden costs.

286. It follows that no positive case was pleaded in relation to speculation and hedging.

287. In opening Busto trailed the possibility of an intention to go wider. At paragraph 93 it was said that Busto "*accepts that the dividing line between what is speculative and what is a hedge will rarely be clear cut. Most transactions will have elements of both. However, where the dividing line in terms of local authority finances is to be drawn is a matter of policy, and in that sense is a matter for the Italian legislature and the Italian Courts"* (suggesting that the answer to the dividing line lay in the authorities – the line which appears from the pleaded case). However that was followed by an indication that Busto intended to show that the Transactions did have a speculative element (unidentified).

288. That approach was further trailed in oral opening. And in closing Busto's case was clearly said to be that by its plea of hedging, DB had advanced a positive case, which entitled Busto to put any positive case on speculation, essentially by way of response.

289. Further, it was suggested by Busto in closing that the question of speculation was effectively decided in *Hazell*; this was in reliance on Lord Ackner at 45F – 46A. However (i) as noted above the analysis on that question has probably moved somewhat under English law in the succeeding years and (rather more importantly) (ii) the case on the dividing line between speculation and hedging is in this case one of Italian Law. It is as impermissible for me to superimpose English Law concepts of hedging as it would be to impose an English Law understanding of the capacity/validity divide.

290. As to the actual case on speculation, Busto's argument extended both to that pleaded case, and a case which developed via the evidence.

291. In terms of the general approach Busto urged me to reach back into *Hazell*, if not adopting the test, at least adopting a similarly sceptical approach. It placed great emphasis on the inherently speculative nature of swaps as described in *Hazell* (which it says resonates with the *Cattolica* approach) and submitted that the claim by the Bank that the Mirror Swap and the Cash Flow Swap were non-speculative and simply hedging must be carefully scrutinised by the court (as in *Hazell*). This is said to be particularly so given that the true nature and effect of a swap may not be immediately apparent, even to experienced bank employees, such as Ms Villa.

292. This was then echoed in Busto's more specific case, which also drew on *Hazell,* contending that there were strong parallels between the interim strategy adopted in *Hazell* and the Bank's case on the Mirror Swap in the present proceedings.

293. I do not consider that this argument by reference to *Hazell* has much effect in circumstances where it is accepted that the Italian law approach is not on a par with that

in *Hazell*, as noted above. While there may be similar resonances my focus needs to be on Italian Law. Further this argument was undercut by the fact that (as I have found above) the 2002 Swap has to be assumed to be valid; which was not the position in *Hazell*.

294. So far as the more general case goes, Busto's pleaded case takes an extreme position that a transaction will be speculative merely because the value or final outcome is uncertain. This would apply to any derivative contract (and indeed to any decision to borrow at a floating rate instead of a fixed rate, or *vice versa*). It is manifestly wrong to give the concept of speculation such a broad reading, not least because Article 3 of the Decree and even *Cattolica* recognises that some derivatives are permitted; and Busto actually accepts that derivatives are not precluded by Italian Law.

295. Accordingly limiting matters solely to the pleaded case, Busto's argument here must fail.

296. This then brings me to the new or extended case advanced by Busto.

297. In relation to this point, Busto sought to argue by reference to the 2018 report by Martingale Risk that the transactions were speculative in that they had a mark to market of negative €15.2 million composed thus:

Component	**Amount €**
Busto Fixed amounts	35,864,914.63
Fixed rate 4.45%	1,234,090.85
Euribor 6m	21,240,148.22
Floor Option 4.62% Fixed rate 0.35% (-) Cap Option 5.6%	1,159,964.73 1,114,443.21 -589,365.03
Floor Option 4.85% Fixed rate 0.35% (-) Cap Option 5.6%	884,733.52 424,216.25 -694,943.56
MtM Payments Busto	**60,638,202.82**
DB Fixed Amounts	49,711,557.67
Euribor 6m	9,358,236.32
Fixed Rate	226,187.10
MTM payments DB	**59,295,981.09**
Implied costs	**1,342,221.73**
Interest Element Busto	24,773,288.19
Interest Element DB	9,584,423.42
MTM Value	**-15,188,864.77**

298. Busto says that the effect of this is that it entered a swap with a negative MTM of €15.2 million and in return for this Busto was given a premium – effectively a loan – of €14 million. Busto contended that this would, under English law, be an obvious example of a speculative contract, namely using an onerous swap to generate short term cash. It was submitted that the interest rate element of the swap was so weighted against Busto

that if interest moved against it, then Busto would stand to lose tens of millions of Euros.

299. Mr Downes submitted that it was speculative because *"it reprofiles a huge amount of fixed interest for variable interest. It is speculative because it generates a fixed payment in favour of Busto, short−term cash of 14 million in exchange for the volatility and risks of the interest rate swap."*.

300. Busto also submits that even if the €14m can be disregarded as being attributable to fixed interest, the swap nevertheless carried a negative mark to market for Busto calculated at €1.3m; involved a significant shift from inexpensive fixed rate interest to risky variable rate interest and extended the repayment burden of the underlying indebtedness which obviously affected multi-year budgets.

301. There are two problems with this submission. The first problem with this approach is that it was not an approach which was properly trailed or pleaded. Busto sought to say that this was a point where the burden of proof was on DB, and that it was perfectly within its rights simply to rely upon the Martingale Risk analysis in closing. However, this was an unattractive submission, not least given the practical and fairness problems with such an approach. The argument hinged on the Martingale Report and on detailed points to be drawn from it. But that report was not pleaded by Busto (the only reference to it in the pleadings was a reference in passing in the Particulars of Claim, which led to a plea that the Transactions were not invalid on the grounds alleged by Martingale (which have not been adopted by Busto and hence are not in issue)), and nor were the features now sought to be drawn from it. That was a necessary step because plainly this sort of financial analysis might well have led to financial experts being called. There was never any suggestion that there would be a need for financial expert evidence about the operation and economics of the Cash Flow Swap. That creates a considerable procedural unfairness, which is exactly what the rules as regards pleading (and indeed the Court's other case management requirements, such as Lists of Issues) are there to prevent.

302. To the extent that it matters I therefore would if necessary have ruled that it was not open to Busto to run a positive case on speculation which went wider than the broad-brush approach outlined in the pleading.

303. The next problem is that even were this argument permissible, it depends heavily on an analysis of the transaction which posits that the additional €14 million in fixed payments from the Bank to Busto was a premium. As I have made clear above, that is not an analysis which commends itself to me as a matter of fact, based on analysis of the Transactions. That aspect of the argument would therefore fail. The argument absent the €12 million was not entirely clear, even in closing.

304. However, such as it was I reject it. There is no evidence to suggest that a small negative mark to market made the Transactions speculative, when considered with the other facets of the deal.

305. As regards the Cash Flow Swap it appears on its face to be a classic form of hedging - seeking to manage and contain the interest rate risks to which Busto was already exposed on its borrowing. The effect of the Cash Flow Swap was essentially to restructure and rebalance the amortisation profile of Busto's principal repayments on

its existing borrowing – in a way which benefitted Busto by delaying the point at which significant repayments had to be made - and to provide for the payment of a variable rate of interest within a fixed range bounded by a cap and a floor. The effect of the Mirror Swap to neutralise the effect of the 2002 Swap which exposed Busto to significant risks if interest rates rose.

306. I conclude that the Transactions were not speculative and were hedging.

Ministerial Decree 389 and Law 448/2001

307. This was the second area where the pleaded case was contentious. This is because in closing Busto sought to run a positive case that the Transactions breached Article 3 of Ministerial Decree 389 of 2003 on the basis that that Article 3 was limited to cases where the local authority was buying, not selling, a floor , the only exception being the sale of a floor where the value of the floor matched a cap. For the sake of clarity the relevant provisions are as follows:

> "….the following derivative transactions are also allowed:…;
>
> c) purchase of an interest rate cap in which the buyer is protected from increases in the interest rate payable above the set level;
>
> d) purchase an interest rate collar in which the buyer is guaranteed an interest rate to be paid, fluctuating within a pre-determined minimum and maximum;…"

308. Again DB said that this case was not properly pleaded – as would have been necessary for appropriate expert evidence to be taken; Busto’s response being that DB's own pleading in reply averred that the transactions complied with Article 41(1) of Law 448/2001 and Article 3 of the Ministerial Decree, and therefore it was open to Busto by way of implied joinder of issue to advance any case which shot that assertion down.

309. I accept the submissions that this argument was not properly pleaded. The plea sought to be advanced is not an implied joinder of issue. It is one which advances a specific positive case which was not pleaded. The plea by DB of the law in question was essentially a defensive pleading, explaining why the Transactions were not speculative and identifying (properly) the foreign laws which are said to be relevant to the definition of speculation as a matter of Italian Law. It was indeed a specific response to a plea by Busto as follows:

> "The Defendant will say ... it is for the Claimant to identify and prove the statutory power (if any) pursuant to which it alleges that the Defendant had the capacity to enter into the Transactions."

310. So: Busto asserted a limitation arising out of Article 119 which DB denied; Busto said, *“And what legal provisions do you say support that?”* and DB replied: *“These: Article 41 of Law 448 and Article 3 of Ministerial Decree 389.”* On that basis I accept the submission that any positive case on Article 3 of the Decree or Article 41 needed to be

identified and pleaded. It was not. Had a new case emerged into Busto's consciousness when the experts produced their reports, there would have been plenty of time to seek to amend the pleadings. This was not done. Indeed, the point having been flagged in opening as an amendment point, Busto made it clear that it had no intention of seeking to amend.

311. However, even had the point been pleaded and therefore properly in play, I would on the evidence before me have concluded that Busto's case on this point was not made out.

312. On the face of it the Transactions fell within Article 3 of the Decree and would appear to be permitted by Articles 3(2)(c) and 3(2)(d). There was no expert evidence which justified the narrow point floated in closing. The Court of Appeal of Milan decision on which reliance was placed in closing was not explored in evidence in this context. Professor della Cananea's evidence was not on point – he cited this authority in passing very much in the context of *Cattolica* section 8 and speculation. The questions which were put to Professor Torchia in cross-examination were not entirely clear, in that they tended to elide the concept of a collar with that of a floor.

313. However, the point has been considered in other cases where expert evidence has been called. In *Dexia v Prato* this point was properly pleaded and argued by reference to evidence. That argument was dismissed by reference to the expert evidence (with Professor Alibrandi's evidence on this being rejected). The judge said this:

> "187 … As Professor Napolitano points out, the circular simply does not say this. What it says is translated as follows:
>
> > The purchase of a collar implies the purchase of a cap and the contextual sale of a floor, permitted solely to finance the protection against an increase in interest rates furnished by the purchase of the cap.
>
> 188. Professor Napolitano had no difficulty in accepting that this passage in the circular represents Italian law. As he made plain in cross examination, what he could not discern was how either article 3.2(d) or the circular supported a suggested requirement that there must be equivalence or equilibrium between the value of the cap and the floor….
>
> 190. I am persuaded by Professor Napolitano that Professor Sciarrone Alibrandi's opinion in this regard does not represent Italian law. As Professor Napolitano observed in Napolitano 1, decree 389/2003 is concerned to implement article 41.1 of law 448/2001. Nothing in article 41.1 calls for an equivalence of the kind asserted by Professor Sciarrone Alibrandi. Moreover, as it seems to me, Dexia rightly adds that there is no inconsistency between the law on the one hand excluding the possibility of a local authority selling a floor on its own but on the other hand permitting the sale of a floor as part of a collar transaction even though the MTM of the floor is greater than the cap."

314. That result was also reached in *Dexia v Piemonte* [2014] EWCA Civ 1298 at paragraphs 75 to 78 with Christopher Clarke LJ saying:

> "There does not seem to me to be anything in Decree 389 which requires the cap and floor costs or values to be evenly balanced….If the validity of a derivative with a floor and a cap depends on an alignment of cap and floor values current at the date of the agreement – a question affording wide scope for argument — the result would appear unworkable."

315. Further the factual evidence which there was did not seem to support the point made, in that:

    i) Busto actually advanced no positive case that the floor was more valuable than the cap;

    ii) Ms Marino acknowledged that it had been common for many years prior to 2007 for Italian local public bodies to enter into interest rate derivatives to manage their borrowing costs and interest rate swaps and collars could be used to provide local public bodies with (greater) certainty over their borrowing costs and were not incompatible with the proper management of public finances.

316. Thus, even if the point had been live, it would have failed. Further even if the point were a good one, it would not get Busto where it wants to go, because breach of the Decree would not give rise to a lack of capacity but only to a breach of a mandatory rule.

Article 42(2) of TUEL

TUEL: was City Council approval required?

317. This issue concerns what can best be described as an apparent fault line between the legislative provisions and a decision of the Council of State on the one hand and the decision in *Cattolica* on the other.

318. Looking first at the situation absent *Cattolica*, the answer to whether City Council approval was needed would appear to be a fairly simple no. Article 42(2) provides that City Council approval is required for certain *"fundamental acts"* which include (at sub-paragraph (i)) – *"expenditure which commits the budgets for subsequent financial years"*.

319. Professor della Cananea accepted that Article 42(2) is to be interpreted narrowly because it is, by its express terms, confined to *"fundamental acts"*.

320. That approach is consistent with the decision of the Council of State (Italy's highest court for administrative law matters) in decision no. 3174/2017. The case concerned the fact that the Municipality of Omegna had authorised the execution and subsequent amendment of certain swap contracts to restructure its debt to Cassa Depositi e Prestiti under multi-year loans and had later issued an invalidation decision by way of administrative self-redress. That decision was challenged by the bank which was counterparty to the swaps in question.

321. At first instance the Municipality was successful, in that the administrative court had dismissed the bank's challenge. However, on appeal the Council of State concluded that the interest rate swaps were debt management instruments and not indebtedness and accordingly did not fall within the scope of Article 42(2). There is a disagreement between the parties as to whether the Council of State was laying down a general rule or one applicable to that contract only.

322. The Supreme Court in *Cattolica* took what seems to be a rather different line – though again the parties disagree as to whether it was making a fairly general statement or dealing with particular swaps. I qualify the question of generality thus because Professor della Cananea accepted that, even on the basis of *Cattolica*, it was not possible to take an *"all-or-nothing approach"* to the application of Article 42(2) to interest rate swaps and that it would only apply to interest rate swaps in the specific situations that are identified in paragraph 10.8 because as he said *"this is not comparable to a mere act of management of the local entity's indebtedness aimed at reducing the financial costs which can be adopted by the city board".*

323. It is therefore necessary to take a view as to just how general each of these decisions was purporting to be. As to the Council of State it seems to me that the submission of Busto has some force and that it certainly can be read simply as a decision that the swaps in that case fell outside the multi-year expenditure case covered by Article 42(2)(i) of the Consolidated Code. That approach appears to be inherent in the use of the word the ("*gli*") before the word "*swaps*" repeatedly at [11-13] of the judgment. However, it is difficult to be clear about this because the factual basis of the decision is not clear – in particular the precise nature of the restructuring is not detailed in the decision. From that it could be argued that if the decision was felt to turn on the precise terms of the swaps one would expect to see more detail of the terms, to explain the point and flag up any issue which might arise in other cases. My impression is that the decision is one made, without much hesitation, on the particular facts of the case; but that the lack of hesitation and precise delineation indicates a sense by the Court that the point is of wider application. That of course would be consistent with the points made above as to the situation absent *Cattolica*.

324. One then turns to *Cattolica* and the question of whether the court here, with the Council of State's decision having been cited as one of the reasons for referring to the joint divisions of the Supreme Court, was laying down a general rule itself.

325. I conclude that the Supreme Court was laying down a general rule – but not one pertaining to all swap contracts. I accept DB's submission that paragraph 10.8 needs to be read with paragraph 10.6 which goes to a question about what is said to affect the total amount of the entity's indebtedness. The Court lays down a rule at 10.6 -10.8 that interest rate swaps require authorisation by the City Council under Article 42(2) if they involve:

i) The payment of an upfront premium/loan (10.8 line 3);

ii) The extinguishment of existing loans (10.8 lines 4-5); or

iii) The significant modification of existing loans (10.8 lines 5-6).

326. What underpins this set of types is:

i) Paragraph 10.6 of the decision which poses the question whether the swap *“affects the total amount of the entity’s indebtedness”*;

ii) Paragraph 10.1.4 which notes that the effect of a swap may overall amount to indebtedness, if it modifies the level of indebtedness;

iii) Paragraph 10.5 which notes that swaps often involve the termination of previous contracts, or amendment of the terms of the previous contract.

327. All of this is, if I may say so, apparently sound good sense. The decision is rooted in the particular case but lays down what one might regard as hallmarks or indicia for other cases where there will be issues. That approach – that swaps can be properly entered into but that there are areas which will require formal authorisation by the City Council - harmonises the legislative provisions (and the consensus as to the respective roles of City Council and City Board) with the *Cattolica* decision.

328. It also seems to me to reflect the evidence of Professor della Cananea who appeared ultimately to accept that, at least generally speaking, swaps are debt management instruments:

> "Q: … swaps are debt management instruments and not indebtedness?
>
> A: I agree with you that this is their function. Then we should consider how they are used, because there might be cases in which swaps are used as a sort of proxy to loans or to other forms of indebtedness. But I agree with you that as a matter of principle swaps are different."

329. That approach is also broadly consistent with the circular dated 22 June 2007 published by the Ministry of Economics and Finance. It will be recalled that that circular expressly states and concludes that swaps are debt management instruments and not indebtedness. While it would be overstating the case to say that this suggests that no derivative transaction would ever amount to indebtedness, regardless of its terms, it certainly provides a fairly strong hint that derivatives were at this time not seen as being generally speaking indebtedness. While the circular does not form part of Italian law and is not, as Prof. della Cananea pointed out, binding on judges, it is an official circular and one would be surprised to find it straying very far from the correct legal position.

330. DB submitted that the conflict between Council of State in decision no. 3174/2017 and the Supreme Court’s decision in *Cattolica* is *“relatively modest”*. As will be apparent from the previous paragraphs, I am not persuaded that there is necessarily a conflict at all. There seems no basis for saying that the swaps in decision 3174 offended against any of the specific sub-types identified in *Cattolica*. It may be that there is a modest clash; but it may also be that what one has is a clash of styles of judgment.

331. On that basis, the question here might be put thus: do the Transactions affect the total amount of Busto's indebtedness – in particular are they swaps which involved an upfront, or involved the extinguishment or significant modification of existing loans so as to give rise to new indebtedness?

332. Those however were not pleaded issues. Had they been pleaded one would have expected financial experts to be called and the points to be specifically identified for the Italian Law experts to deal with. As it was, there was no relevant expert evidence and none of these points was zeroed in on by the Italian Law experts.

333. There was therefore significant resistance from DB to Busto being allowed to run the case advanced in closing that there was significant modification of the underlying indebtedness because:

i) There was an extension of the term, and a switch from low fixed rates to onerous variable rates;

ii) Part of the cash generated by the interest rate element was used to fund the Mirror Swap.

334. Strictly speaking I again consider that DB was right to argue that this case was raised too late essentially for the reasons which I have previously given. However, in the end and considering the point *de bene esse* I consider that the result would have been the same; as is often the case, the late arising point is not a good one.

335. As I read the *Cattolica* decision (in particular at 10.5 and 10.8), in the light of the other decisions considered in the evidence, and in the light of the expert evidence, the key point which the Court is addressing is whether the swap or swaps affect multi-year budget costs. What the Court says is this:

> "Authorisation for Italian Municipalities to conclude a swap contract, especially if they are of the type with an upfront loan, but also in all cases where its negotiation entails extinction of the previous underlying loan agreements or even if they remain outstanding, but with significant modifications, must be given…"

336. Where, as here, we are looking at the conclusion of a deal which involves previous loans/swaps which remain outstanding the Court has to ask the question of whether there is *"significant modification"* against a consideration of the amount to be paid overall and the number of years. It also seems clear that what is required is a view of the transaction overall (see paragraph 10.1.4 *"a swap transaction must be examined as a whole"*) – consistent with the legislative background of *"fundamental acts"* and the Court's own reference to *"significant modification"*. Just as the label attached to a transaction cannot be determinative (*Cattolica* points up the possibility of a swap being in reality a loan), where a transaction has more than one component the Italian Courts would look at those organically.

337. Therefore while Professor Torchia did, as Busto noted in closing, accept that the use of cash generated by the Cash Flow Swap to fund the Mirror Swap would not be investment, that is to ask a question on too "*micro*" a level; it is necessary to pan out and look at the transaction overall, in particular with an eye to the questions of: (i) is more paid over the period of years and (ii) is that period of repayment changed? These are questions which are key to a consideration of the effect on the total amount of indebtedness (*Cattolica* 10.6, 10.1.4) and the significance of any modification (*Cattolica* 10.8).

338. To these questions the answer is no. As to the period of repayment the answer is an obvious one. As to the question of whether more was to be paid, the answer was that on the basis of projections at the time considerably less would be paid; though of course as matters have turned out more has been paid.

339. As I have already noted, the economic effect of the Mirror Swap was simply to cancel out the 2002 Swap. It is self-evident that this cannot have brought about any *"significant modification"* in relation to any of Busto's underlying borrowing.

340. Again, as noted, the economic effect of the Cash Flow Swap was to rebalance the amortisation profile. There was no question of Busto incurring any obligation to pay back a higher principal amount. As the name suggests, it was a cash flow measure in which the principal exchange amounts net to zero over the life of the swap.

341. The Cash Flow Swap did not result in any modification let alone a *"significant modification"* in relation to any of Busto's underlying borrowing. Busto was already required to budget for repayment of the principal amount of its underlying borrowing. It did not result in Busto incurring any new indebtedness or committing itself to any new expenditure.

342. The only element of the Transactions which involved any degree of uncertainty was the interest collar element, but that actually limited Busto's exposure to interest rate risk within the range bounded by the cap and the floor. While it is true that whether or not Busto would be the net payer or the net recipient under the interest collar depended on the future path of interest rates, it did not involve "*indebtedness*" or expenditure commitments for the future. It cannot therefore be said to involve any *"significant modification"* of Busto's borrowing.

343. I therefore conclude that, based on the evidence called, the Transactions did not require City Council approval.

344. For completeness I should add that DB tacitly invited me to express a view that the approach of the Council of State is to be preferred over the approach of the Supreme Court. As I have indicated above, I conclude that there is either limited or no real conflict and therefore it would be neither necessary nor appropriate to do so.

345. However, I do note that the materials before me indicate that the point is one which is controversial and there is a fair amount of scholarship which takes the view that interest rate swaps are debt management instruments *simpliciter* and not indebtedness. The Council of State followed that standard approach.

346. The Supreme Court took a different view in *Cattolica* in relation to interest rate swaps involving an upfront premium and some other swaps which involve extinguishing or making "*significant modifications*" to existing indebtedness. I understand that there may be said to be an oddity in that it did not refer to, let alone explain its reasons for departing from, the view that interest rate swaps are debt management instruments in some cases.

347. Having said that I am not necessarily minded to accept the full extent of DB's criticisms of the *Cattolica* decision.

348. DB complains that the Supreme Court also did not explain what would amount to a "*significant modification*" of borrowing which *"affects the total amount of the entity's indebtedness"* and that Professor della Cananea's "take" on this which suggested that the Supreme Court's decision was based on whether, in the absence of an upfront, *"there are financial consequences that are against the fixed nature of the rules of public finances"* was unworkable. It also placed some reliance on the fact that Professor della Cananea was unable to offer any real guidance as to when swaps would fall foul of the rule in *Cattolica*.

349. As is perhaps apparent from what I have said above, I would tend to read the *Cattolica* decision as one which gives indicia allowing for a sensitive fact based approach. The fact that Professor della Cananea was not able to adumbrate the operating area of that test does not prevent it being an effective one. But this is a matter for the Italian Courts to work out, whether by adopting the purist line advocated as the intellectually correct position by Professor Torchia or exploring and defining the dichotomy posed by the *Cattolica* test in certain cases.

350. My conclusion on this issue therefore is that there is a rule, that it is to some extent different to the widest reading of the Council of State decision, but that had it been pleaded and run with due notice I would still have concluded that City Council approval was not needed on the facts of this case.

351. It follows from this conclusion that Busto's defence to the Article 42 point fails.

Was there approval? (City Council Resolution 32/2007)

352. I will nonetheless deal here with DB's secondary case, which consequently does not arise. That case is that if Article 42(2)(i) did require City Council approval then such approval is to be found in the City Council's resolution No 32 of 2 April 2007.

353. Busto originally suggested that this resolution was no more than a resolution *"to investigate a potential avenue and report back"*, but shifted the focus of argument somewhat by closing. At that stage it contended that this argument does not work because the resolution was not sufficiently detailed. It points out that in *Cattolica* itself the Supreme Court found that a guideline (which existed in that case) was not sufficient. It refers to paragraph 10.4.1 of *Cattolica*, where it says the Supreme Court justifies the requirement for City Council approval in the following terms:

> "The city council must evaluate the cost-effectiveness of the transactions that may constrain the use of future resources and make clear that the local entity's transaction must follow the rules of public accounting that govern the carrying out of the responsibilities of entities that use public resources"

354. Busto placed emphasis on the requirement for the City Council to evaluate the cost-effectiveness of the proposed transaction in circumstances where the proposed transaction may constrain the use of future resources and submitted that:

i) The City Council cannot evaluate the cost-effectiveness of a proposed transaction without being told the financial terms of the proposed transaction – here it must be able to assess the re-profiling effect of the debt;

ii) As of 2 April 2007, the tender process had not been undertaken, the Bank had not submitted its proposal, and the consortium appointed to review the tenders had not reported.

355. On this basis, it contended that Busto's City Council was not in a position to consider in April 2007 the cost-effectiveness of a transaction that had yet to be proposed to Busto by the Bank and that is reflected in the fact that the City Council Resolution No 32 of 2 April 2007 does not contain anything remotely like sufficient information to enable the City Council to evaluate the cost-effectiveness of the proposed transaction.

356. However, when one looks at the documents in context this argument appears strained. The context for the argument takes in the respective roles of the City Council and the City Board, to which I have already referred in the introductory section of this judgment – and which Professor della Cananea accepted.

357. If, as the evidence demonstrates, the role of the City Council within the municipal administration is to set overarching policy and guidelines, with the City Board and the administrative departments implementing that policy, it is to be expected that the City Council would exercise its powers in a way which left room for the City Board to exercise its own political discretion. That the City Board has such powers was accepted by Professor della Cananea.

358. Here the City Council set out in a forecast and planning report the fact of Busto's financial difficulties and stated that *"[i]n order to remedy this situation, the following fiscal manoeuvre was set for 2007"*. It specifically contemplated and approved the *"use of financial instruments that are useful for debt restructuring through a swap on interest and principal"*. The information available to the City Council included a description of the proposal to use derivatives. This goes a considerable way beyond authorising the exploration of an avenue. Plainly the City Council thought that it was authorising the transaction to the extent that it needed to do so; it did not anywhere indicate that it expected to do the exercise which the City Board then undertook. On the contrary, it approved the budget, complete with its explanatory note setting out the effect of the terms and the transactions.

359. That is reflected in the documents as to the City Board's understanding. They make clear that the City Board and Mr Fogliani considered that they were implementing the guidelines or instructions that had been given to them by the City Council. This can be seen in executive decision no. 403/2007, the invitation to tender, City Board resolution no. 398/2007, and executive decision no. 489/2007.

360. If one follows the approach advocated by Busto, one arrives at a somewhat *"Through the Looking Glass"* situation where both City Council and City Board think that they are doing the appropriate things, things which are consistent with the general nature of each entity and its role as a matter of law, but the transaction fails because the City Council should instead have micro-managed the entirety of the process, leaving the City Board effectively with nothing to do. That would be a strange conclusion. It is one which I consider the Italian courts would be slow to reach; and consequently, one which I would not be minded to reach.

361. Is it one to which I am (or the Italian Courts would be) driven regardless of this by paragraph 10.4.1 of *Cattolica*? To recap, that paragraph says:

> "The city council must evaluate the cost-effectiveness of transactions that may constrain the use of future resources and make clear that the local entity's transaction must follow the rules of public accounting that govern the carrying out of the responsibilities of entities that use public resources."

362. I do not consider that it is. Paragraph 10.4.1 of the *Cattolica* decision has to be read in its own context. In section 10 the Court was grappling with the concept of indebtedness and upfronts against the backdrop of the particular transactions which had those specific features. It forms part of the lead up to the limited general rule I have indicated above. Even if (contrary to my decision on that issue) one reads this section as setting down a wider general rule (as *ex hypothesi* one must if this point is to arise), paragraph 10.4.1 remains as backdrop to that analysis. In this paragraph it is simply recording in general terms the role of the City Council; it is not purporting to lay down any general rule, or to draw a line as between the responsibilities of the City Council and the City Board.

363. Were it purporting to do so one would expect to find some consideration of the respective roles of the City Board and the City Council, and/or the authorities such as Council of State decisions no. 6764/2002 and no. 4192/2013, which explain those roles; but there is no such consideration.

364. Accordingly, I conclude that there is nothing in Cattolica 10.4.1 which forces a conclusion other than the one at which I had provisionally arrived. It follows that if City Council approval was required it was given.

Determination and matters for consequential argument

365. It follows that I conclude that:

    i) The Transactions complied with the requirements of Article 119;

    ii) Article 42 paragraph 2(i) of TUEL is not applicable, but in any event the Transactions complied with the provisions of Article 42 paragraph 2(i) of TUEL by virtue of Resolution number 32 of 2 April 2007;

    iii) The Transactions are valid and binding on Busto and are enforceable in accordance with their terms.

366. In essence, therefore DB's claim succeeds. There do however remain issues as to the terms of the declarations sought, the determination of the sums due and outstanding and interest. These if not agreed will require to be determined at a consequentials hearing.

Part 3: Contingent Issues

The other TUEL issues

367. These questions therefore only arise on a double contingency (i.e. if I am wrong as to whether City Council approval was needed and also as to whether if it was needed, it was given). I deal with them only for completeness.

Status of the resolutions of the City Board and Mr Fogliani

368. So far as concerns the consequence if (i) City Council approval were necessary and (ii) it had not been given, there is a vibrant debate to be had as to whether that consequence should be annullability and not nullity.

369. The issue is particularly tricky because on the face of it the merits of the point appear to lie with DB; but there is no doubt in this case that *Cattolica* goes the other way. Professor Torchia gave it as her clear opinion that *Cattolica* is in this respect wrong. Professor della Cananea agreed that "*as a general rule*" relative incompetence results in annullability (not nullity), and that the "traditional" approach to breach of Article 42(2) would be treated as "*a breach of the rules of internal competence*" (i.e. relative incompetence) and that the result of this is that administrative acts adopted in breach of Article 42(2) would be treated as annullable (not a nullity).

370. This is a point which I do not have to decide. Had the point arisen I would, with considerable hesitation (bearing in mind what I have said above about the approach to foreign law), have concluded that despite what is said in *Cattolica* the correct position as a matter of Italian law is that a breach would result in relative incompetence i.e. annullability.

371. For this double contingency the briefest of reasons will suffice:

i) *Cattolica* is not the starting point; the backdrop of the law prior to *Cattolica* is clear and in DB's favour, as noted above;

ii) Even in the Court of Appeal in *Cattolica* this line appeared to be followed with no reference to voidness but reference to *"potential annulment"*. That is plainly a reference to annullability;

iii) The Supreme Court decision does not engage with the previous law or explain what would on its face be a significant change. While clearly expressed the relevant part appears to be a statement in passing. There is no suggestion in the judgment that any issue was even raised as to the consequences of a breach of Article 42(2), let alone any explanation for any departure from the traditional approach;

iv) While very great respect is due to the Supreme Court's decision, there is no doctrine of precedent in Italian Law and the academic views, together with Council of State decision 2810/2018 (albeit not exactly on point), gives sufficient basis to conclude that the Italian courts would probably not follow *Cattolica* on this point.

372. The result of this is that the relevant acts of the City Board and Mr Fogliani are thus effective in law unless and until they are set aside. Professor della Cananea accepted that an annullable administrative act is valid and effective and that the public body is therefore bound by it once the time limit for challenging it in the administrative court or taking self-redress procedures has passed.

A limit on capacity

373. Similarly, I accept the submission that Article 42(2) is not a limit on capacity. The contrary was not separately argued in closing.

Ratification

374. The starting point is that for this point to arise one must assume that the Transactions breached Article 42(2)(i) of TUEL but that (as I have contingently found) the consequence is annullability not voidness.

375. The first question is that of which law is applicable to these issues. Busto were not unnaturally keen for the matter to be considered as a matter of Italian law given that (i) Professor Torchia accepted in her first report that the subsequent resolutions did not amount to ratification as a matter of Italian administrative law and (ii) in the joint memorandum of Professor Perrone and Professor Alibrandi they agree that ratification is not available as a matter of civil law in the case of a void contract. I accept that were the proper law to be Italian Law Busto would win this argument (for brevity on this extremely contingent point: essentially for the reasons given by Busto).

376. However, matters are by no means so favourable to Busto if, as DB contends, the applicable law for any ratification argument is English Law.

377. It is common ground that in the conventional case the putative law of the contract (here English Law) will also govern questions of the scope of the agent's authority including ancillary questions of ostensible authority and ratification, see Dicey & Morris on the Conflict of Laws 15th Ed. at Rule 244.

378. But Busto contends that there is an important rider which is applicable where authority and capacity coincide – i.e. where the limit on authority is derived from a limit within the relevant body's constitution. Thus, it points to Bowstead & Reynolds on Agency 22nd Ed., paragraph 12-021, where the authors state:

> "There can be little doubt that if there are public law restrictions on an agent's authority, as in the case of public officials, these should be effective as against the law governing the main transaction. As regards public officials, it seems to be accepted that constitutional and other public restrictions of a disabling nature on their actual authority should be effective, and the interpretation of such restrictions is a matter for the law imposing them; although in the absence of clear evidence the court falls back fairly easily on English interpretation techniques, at least where the governing law of the main transaction is English, and similarly estoppel, apparently under English law, has been applied to later conduct relevant to earlier authorisation. The reluctance of English law to find apparent authority in public officials has recently been applied in the context of foreign officials".

379. This would also seem to be consistent with the "*internationalist*" approach referred to in *Haugesund*. However, it appears that this argument is slightly off point; we are not here concerned with public law restrictions on an agent's authority.

380. Further Bowstead and Reynolds paragraph 12-019 notes that *"where there is no question of lack of power, the matter is likely to be one of authority only and governed*

by the law applicable to that topic", by reference to *Law Debenture Trust v Ukraine* [2018] EWCA Civ 2026; [2019] Q.B. 1121.

381. In reply, Mr Downes tacitly accepted the applicability of that passage and simply submitted by reference to *PEC v Asia Golden Rice Co* [2014] EWHC 1583 (Comm) that there might be a carve-out where it would be unfair to do so, and that on that basis it would be unfair to fix the principal with the chosen law of a contract that the principal did not enter into. However, that authority does not provide full support for this argument. At [75] of *PEC* Andrew Smith J went no further than to say:

> "I also have sympathy with his submission that the general principle stated in Dicey, Morris & Collins would not be applied if it resulted in distinct unfairness or there were other strong reason for modifying it. An obvious example might be if an agent chose a law unconnected with the contract simply to clothe himself with authority."

382. The situation to which he refers is not the situation in this case. It follows that in my judgment to depart from the default position would be unjustified in this case. The question of ratification would (if it arose) therefore fall to be considered by reference to English Law.

383. So far as English Law is concerned, Busto's case on the law was notably understated, with broad allusion to ratification requiring an unambiguous act coupled with informed consent. No reference was made to the authorities cited by DB to the effect that:

i) The question whether an intention to adopt a contract as binding should be inferred from silence depends on whether it is the only reasonable conclusion to draw in the circumstances. *ING Re (UK) Ltd v R&V Versicherung AG* [2006] EWHC 1544 (Comm) at [161];

ii) There is no legal requirement that the principal must be aware of his agent's lack of authority before the principal can be taken to have ratified a contract. The key is knowledge of the material facts: Bowstead paragraph 2-067, which in turn cites *Brown v InnovatorOne plc* [2012] EWHC 1321 (Comm) at [856-7]; *SEB Trygg Holding AB v Manches* [2005] EWCA Civ 1237, [2006] 1 WLR 2276 at [43].

384. Is there sufficient material to satisfy the test on that basis? DB relied on:

i) The City Council's recognition of the Transactions in the budget and the supplemental notes to the budget in every year from 2008;

ii) The City Council permission to Busto to make the payments due under the Transactions from 2007 through to June 2020;

iii) The absence of adoption of any administrative self-redress procedures to annul the resolutions of the City Board or the decisions of Mr Fogliani within the time allowed by Article 21-nonies of Law 241/1990 by Busto;

iv) As regards the latter DB says these are particularly striking given that, as noted in the factual section of this judgment, Busto retained Brady Italia in early 2009 to investigate the legitimacy and validity of the Transactions and it produced a further report on the Cash Flow Swap in 2012, but Busto did not raise any issues with DB.

385. I accept the submission that these matters are sufficient to make out a case of ratification as a matter of English Law. Busto's conduct in these regards is wholly inconsistent with Busto now taking the position that Mr Fogliani did not have authority to enter into the Transactions on behalf of Busto because they had not been approved by the City Council.

386. I therefore conclude that if ratification had arisen, the proper law is English law and the requirements of ratification would be made out.

Ostensible authority/Contractual estoppel

387. I deal briefly with this point largely because it raises an issue of law in an area of considerable interest which is not replete with authority.

388. This was an argument taken fairly lightly by DB and rather more seriously by Busto.

389. DB relies upon the terms of the ISDA Master Agreement, in particular the contractual representations and warranties set out in section 3(a)(ii) ("Powers"), section 3(a)(iii) ("No Violation or Conflict"), section 3(a)(iv) ("Consents"), section 4(b) ("Maintain Authorisations"), and section 4(c) ("Comply with Laws") of the Master Agreement (as amended by the Schedule).

390. DB contends that these representations survive any voidness of the swaps themselves because the Master Agreement is a framework agreement which did not entail any binding commitment for Busto to incur expenditure that needed to be budgeted for in future years and did not necessarily involve Busto entering into any derivative contract with DB which would (on Busto's case) require City Council approval.

391. It therefore submits that:

i) Article 42(2)(i) of TUEL cannot require City Council approval of the Master Agreement and Schedule;

ii) The City Board authorised Mr Fogliani to enter into the Master Agreement and Schedule by decision no. 417/2007 of 17 July 2007;

iii) Busto is therefore bound by the express contractual representations and warranties that it gave to DB in the Master Agreement including the terms which specifically confirmed Mr Fogliani's authority to enter into the Transactions on behalf of Busto.

392. DB contends (i) that these representations and warranties in the Master Agreement are sufficient to establish a contractual estoppel which prevents Busto from denying that Mr Fogliani was duly authorised, and (ii) that estoppel arises without the need to establish reliance by DB.

393. Busto argues that it is logically impossible (and "bootstraps") for a local authority to represent (sufficient to give rise to some form of estoppel) that a transaction is within its capacity as a means of evading what would otherwise preclude its entering into the transaction.

394. Reliance was placed by Busto on the trenchant observation of Harman J in *Rhyl Urban District Council v Rhyl Amusements Ltd* [1959] 1 WLR 465 that:

> "Accepting the view… that the Minister had no power under the regulations to grant a tenancy, it is perfectly manifest to my mind that he could not by estoppel give himself such power… It would entirely destroy the whole doctrine of ultra vires if it was possible for the donee of a statutory power to extend his power by creating an estoppel. That point, I think, can be shortly disposed of.'"

395. Busto also pointed to the judgment of Tomlinson J in *Haugesund*, rejecting an argument based on estoppel at paragraphs 170-172:

> "[170] At para 35 above I set out the representations which are attributed to Haugesund in the ISDA Master Agreement. ... Wikborg Rein contends that these representations form the basis of an estoppel by representation pursuant to which the municipalities are, as against Depfa, precluded from denying that the swap agreements imposed on them valid and binding obligations. In the alternative, Wikborg Rein contend that the municipalities owed to Depfa a tortious duty of care in making the representations as to their power to enter into the agreements and that they made the misstatements negligently, so that in consequence Depfa has a cross-claim in damages against the municipalities to the extent of its inability to recover in contract or in restitution. …
>
> Both of these arguments must in my view fail on the simple ground pointed out by Professor Graver that "there can be no power under administrative law for public bodies themselves to create new powers by representing that they have such powers". Unsurprisingly Professor Graver's evidence was not challenged. Mr Mitchell distinguishes between a power to enter into a contract and the power to make a statement independently of contract. I agree that the concepts are different, although the representation here is made in connection with the making of the contract and, insofar as negligent misstatement is concerned, liability is only established if there is a relationship "equivalent to contract" – cf per Lord Devlin in Hedley Byrne & Co v Heller & Partners Ltd [1964] AC 465 at 530, [1963] 2 All ER 575, [1963] 3 WLR 101. However the answer to Mr Mitchell's point is given by Professor Graver. It was given too by Harman J in Rhyl UDC v Rhyl Amusements Ltd … where he pointed out that arguments of this sort which might avail against "private people"

> cannot prevail as an answer to a claim that something has been done by a statutory body without it having the capacity so to do."

396. In opening DB relied on *Standard Chartered Bank v Ceylon Petroleum*. In that case, Hamblen J held that representatives of CPC had ostensible authority to enter into the relevant transactions in that case in light of, *inter alia*, a representation in an ISDA Master Agreement that CPC had power to execute the Master Agreement and any Confirmation and had taken all necessary action to authorise that execution. It says that Busto made similar representations to DB in the express terms of the Master Agreement.

397. However *Standard Chartered* was a case where the argument was purely one of ostensible authority, and the judge relied on matters (such as the statute which created CPC and specific acts of the Board) which went well beyond the ISDA Master.

398. The main authority deployed by DB in closing was that of *Credit Suisse International v Stichting Vestia Groep* [2014] EWHC 3103 (Comm) in which Andrew Smith J considered a challenge to five disputed contracts entered into by a Dutch social housing association based on a lack of capacity. It was common ground that Vestia had capacity to enter into the ISDA Master Agreement framework contract; the dispute was limited to some but not all of the transactions Vestia entered into under it.

399. In respect of three of them ((i) transactions 3, 4 and 5; (ii) transactions 7 and 8; and (iii) transaction 9), the Judge found them to be ultra vires. Credit Suisse then advanced three further arguments: estoppel, warranty and misrepresentation.

400. In particular Credit Suisse sought to rely on two "Additional Representations" that Vestia had given in the ISDA Master Agreement:

    i) First, the "compliance representation" – that its entry into and performance of its contractual obligations was and would be in compliance with its articles, financial rules and any other applicable laws or regulations; and

    ii) Second, the "hedging representation" – that it was entering into each transaction purely for the purpose of hedging its exposures and not for the purpose of speculation.

401. At [300] of the judgment the Judge held that these were intended to take effect as contractual undertakings as well as representations.

402. Credit Suisse then argued that both the Master Agreement and these Additional warranties/representations estopped Vestia from contending that the transactions were void. As regards the Master Agreement itself, the Judge rejected this argument at paras 304-305, citing the line of argument upon which Busto now relies and going on:

> "[304] …. Mr Howe accepted that this is so in the case of local authorities or other public bodies, but submitted that Vestia are in a different position because, though they operate in the field of social housing, they are a private entity.

> [305] Professor Dorresteijn's evidence was that Vestia and other SHAs "are not part of the governmental organisations", and I accept this. But I do not consider that this assists Credit Suisse, or that Vestia could have extended their contractual capacity by representing (by contract or otherwise) that they have powers which they do not have or that it is within their powers to make a contract when it is not. A contract that is ultra vires the powers of a company is void, and it cannot be validated: see Chitty on Contracts (31st ed, 2012) vol 1 at paras 9-020 and 9-024, citing the judgment of Russell J in York Corp v Henry Leetham & Sons [1924] 1 Ch 557, 573, 22 LGR 371, 94 LJ Ch 159: "An ultra vires agreement cannot become intra vires by means of estoppel, lapse of time, ratification, acquiescence, or delay". Although this was said in the context of the capacity of a local authority, the editors of Chitty clearly understand it to be a wider statement of principle, and I agree. The same is said by the editors of Spencer Bower, The Law relating to Estoppel by Representation, (4th ed, 2004) at para VII.6.1: "nor [can] a company become entitled by estoppel to exceed its statutory powers or those given to it by its memorandum of association". The position relating to companies incorporated under the Companies Acts is illustrated by Ashbury Railway Carriage and Iron Co v Riche, (1875) LR 7 HL 653, 44 LJ Ex 185, 24 WR 79 and Great North-West Central Ry v Chamlebois [1899] AC 114, 68 LJPC 25, 79 LT 35. In my judgment the representations in the Master Agreement and the Management Certificate do not enable Credit Suisse to argue that Vestia are estopped from disputing that the ultra vires contracts were within their capacity or from disputing the authority of Mr de Vries and Mr Staal to make the ultra vires contracts."

403. The Judge went on to accept the alternative argument that the Additional Representations in the Schedule to the Master Agreement gave rise to an estoppel. At [307-309] he considered that the doctrine of contractual estoppel could apply an agreement about a state of affairs in the future. At [312-318] he decided that the representations could apply to ultra vires transactions.

404. At [319], Andrew Smith J considered whether Credit Suisse's reliance on these Additional Representations fell foul of the principle in *Rhyl UDC*:

> "Would the Additional Representations so interpreted be inconsistent with a policy or principle of law that an entity cannot expand its own capacity by estoppel or contract? In my judgment they would not be. I readily accept that an entity cannot achieve what it has no power to do simply by stating or promising that it has the power, and that underlying the doctrine of ultra vires is a policy of protecting the public: see Hazell v Hammersmith and Fulham LBC, [1992] 2 AC 1, 36F/G per Lord Templeman. But there seems to me no reason that a legal entity should not in a valid contract undertake that the contract will not be used as a vehicle for purported transactions that are invalid because they

> are outside their capacity. Credit Suisse are not making a claim under the ultra vires contracts and in this part of their claim are not asserting that they are valid. Their argument is that they are entitled to enforce the Master Agreement as if the ultra vires contracts were valid."

405. Andrew Smith J therefore concluded that it was not inconsistent with the *Rhyl* case or its underlying policy for Credit Suisse to make a claim for estoppel or breach of warranty based on the Additional Representations in the Master Agreement, as opposed to claiming under the *ultra vires* transactions themselves.

406. The consequence was that Vestia was contractually estopped from disputing its liability to Credit Suisse under the Master Agreement on the grounds that the *ultra vires* contracts were made without capacity and authority, or alternatively that Vestia was liable in damages for breach of warranty: [320]-[322].

407. Interesting as this argument is had the point arisen, I should have been unwilling to conclude that a contractual estoppel arose in this case. The doctrine is one which has been established on a very narrow basis and has yet to receive endorsement from the Supreme Court. There are some expressed concerns in the academic commentaries about its principled basis and capacity for uncontrolled growth (See, for example, Braithwaite *"The origins and implications of Contractual Estoppel*" LQR 2016 pp 120-147, Leeming *"Receipts Clauses and "contractual estoppel" revisited"* LQR 2018 pp 171-76, Wilken and Ghaly, Law of Waiver, Variation and Estoppel, 3rd edn, at pp.90–91 and 315). It is right therefore to look at any development which would cut across a line of authority on such a fundamental question as capacity with some care.

408. Here I would see sufficient grounds for caution. In *Vestia* it was common ground that the ISDA Master Agreement was within the capacity of the entity, which was not a public body but a private entity. In *Vestia* the representations within the Master Agreement were still regarded as not capable of giving rise to a contractual estoppel. The particular conclusion upon which the argument within *Vestia* is built is a very particular one, derived from certain specific "*Additional Representations*" which did not exist in this case. While DB contended that there were similar representations (i) they were not additional representations, but ones within the main Master (ii) they were not the same as the representations in *Vestia* and no time was spent establishing an equivalency and (iii) the building block of establishing them as contractual warranties which formed part of the analysis in *Vestia* was not done here. Although DB placed reliance on my judgment in *BNP Paribas SA v Trattamento Rifiuti Metropolitani SPA* at [176]-[184] as stating that the distinction was not significant that strikes me as an over-reading of a passing line within that judgment, which was not part of the determinative reasoning.

409. Further, coming back to basics, on their face the representations relied on are referable to the "Transactions" - which are defined as transactions that the parties have entered into or anticipate entering into. It logically follows that to the extent that the transactions are void for want for capacity they do not fall within the definition of "Transactions".

The restitution claim

410. These issues would only arise if the Transactions were void. Busto's restitution claim is for €3,840,166.74 (i.e. the net sum paid to DB under the Transactions).

411. The first issue which was raised was that of applicable law, the candidates again being Italian and English Law, with DB arguing for English Law, despite the decision of Walker J in *Dexia Crediop SpA v Comune di Prato* [2016] EWHC 2824 (Comm) at [159]-[172]. Had it been necessary to decide this point I would have concluded that this authority was distinguishable. While I would not necessarily place the same weight as did DB on the technical survival of the ISDA Master Agreement, there is force in the submissions that: (i) that choice of law would retain weight under the *Haugesund* approach of adopting the putative applicable law to determine the civil law consequences of a lack of capacity on the validity of a contract; and (ii) the facts of this case are also distinguishable from *Dexia* because Dexia was an Italian bank, whereas DB acted through its London branch. The place of enrichment in this case would therefore also be England. Overall, therefore, despite the existence of certain ties to Italy, I would conclude that the closest and most real connection for the putative Transactions was with England.

412. That would then have led into limitation and change of position arguments under English Law (which it was common ground would not exist under Italian Law). There was little controversy that if English Law governed, all the payments made by Busto under the Mirror Swap were made outside the limitation period; leading to a sum of €99,136.88 being time barred.

413. As for change of position, this was used to found a claim for hedging costs. DB contended that their hedging costs were over €4 million, and thus outweighed Busto's restitution claim.

414. There are two problems with DB's contingent claim on this basis. The first is that there are two first instance decisions in which it has been held that payments made under hedging contracts did not give rise to a change of position defence: *Westdeutsche Landesbank Girozentrale v Islington LBC* [1994] 4 All ER 890 at 948-949 and *South Tyneside MBC v Svenska International plc* [1995] 1 All ER 545 at 558-569.

415. There is plainly a very interesting debate to be had on another occasion as to these authorities. For present purposes I can briefly indicate that in the light of Foxton J's recent decision in *School Facility Management Ltd v Governing Body of Christ the King College* [2020] EWHC 1118 (Comm) at [470]-[478], where the academic criticisms of those cases are carefully considered, and other cases where the defence of change of position was upheld also examined, I would not have been minded to follow these judgments.

416. The second however is more substantial. It is the lack of evidence on this point. This claim effectively hinged on a single, rather terse, internal DB email sent on 18 July 2007 which was not explained in any detail by anyone who was a party to it. There seemed also to be a tension between that approach and the credit approval documents which contained a suggestion that any hedging would only be for US$10 million. Aside from this the case on hedging rested on the evidence of Mr Tarczynski, who was ultimately not called. Mr Tarczynski was not an employee of the Bank at the time the Bank alleges that it entered the hedging arrangements, and hence had no first-hand knowledge of the Transactions in this case or the alleged hedging arrangements. In

substance, Mr Tarczynski sought to give evidence as to what he believed the Bank would have done based on his experience as a hybrid options trader in the interest rate trading department at Lehman Brothers.

417. At the PTR there was a lively dispute about the contents of this statement with Busto contending that Mr Tarczynski's evidence contained inadmissible opinion evidence. I largely concurred with that submission, with the result that a revised draft was served in order to cure this defect. The contents of the draft remained contentious, though no detailed argument was addressed to it in circumstances where the statement was withdrawn.

418. Ultimately it seemed to me that Busto's submission that the evidence on this point was insufficient to prove the hedging arrangements, was correct.

Article 1338

419. Finally, I will touch on the alternative claims under Article 1338 of the Italian Civil Code, which provides:

> "A party who knows or should know the existence of a reason of invalidity of a contract and does not give notice to the other parties is bound to compensate for damages suffered by the latter relying, without fault, on the validity of the contract."

420. The first question is whether this claim is governed by Italian law. As to this there was no contest that Italian law applied to this claim. Busto did not advance a positive case for any other law.

421. The principal issue between the parties in relation to the Article 1338 claims was whether either of Busto knew or ought to have known of the alleged grounds of invalidity now relied upon by it (i.e. alleged non-compliance with Italian public finance laws and/or Article 42(2)(i) of TUEL) and, if so, whether DB was "*without fault*".

422. DB relied on a general principle of Italian law that a public body, such as Busto, is required under Italian civil law to know of any fact, event or administrative measure that is a requirement of any law applicable to it as a public body or any transaction which it purports to enter, unless it is impossible to have such knowledge.

423. I was not attracted by this line of argument. It rests on an assertion that Busto was under an absolute duty to know the law. I was not persuaded that the authorities relied upon to establish that proposition did so; they rather seemed to support a more conventional negligence/diligence test. Absent that absolute duty on the facts it is hard to see how it can be said that Busto "*ought to have known*" that the Transactions were invalid. And, while I was not persuaded that the arguments as to DB's "*incomparable experience*" had any legal significance, there would certainly seem to be an oddity if there is no absolute duty for those involved in a small local authority to be in the position where they ought to have known more than a group of professional specialists with extensive specialist legal advice.

424. Further the "*incomparable experience*" would have had a significance at the next stage – whether there was reliance by DB "*without fault*". In circumstances where the burden

is on DB to establish this aspect, and the evidence suggests not only their general level of knowledge, but a failure to take specific advice at the time, I would have found that this hurdle was not cleared.

425. On any analysis therefore the Article 1338 claim would have failed.

426. But in any event for the reason I have already given I would have found that the quantum of DB's claim was not proved.