DIRITTOBANCARIO approfondimenti

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Recent decisions of Italian Courts on Interest Rate Swaps

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1. Introduction

In trying to find the right facts and give the appropriate conclusions of law concerning Interest Rate Swaps (**IRSs**), the Italian courts have recently made vast recourse to the "doctrine of cause" which, in Civil law legal systems, is vaguely comparable to the "doctrine of consideration" of Common law countries.

As it is widely known, under the modern Civil law of most European countries (including Italy), the existence of a valid and legitimate cause is necessary for the agreement to be binding. For long time, the Italian courts had found that under an IRS the "typical cause" of the relevant parties was that to swap a fixed rate interest obligation under a loan for a floating rate interest obligation. However, beside being used as commercial hedges, IRSs are also commonly employed as speculative investments and they might also have a variety of other uses.

With this in mind, this note provides an overview of the most recent Italian case law relating to IRSs, describing the circumstances in which they have been declared invalid, and the practical considerations relating to each decision.

The views taken by the courts can be grouped into three categories: (i) IRSs declared invalid because they lacked the hedging purpose for which they had been entered into; (ii) IRSs declared invalid because they were unsuitable to achieve the purpose for which they had been entered into; and (iii) IRSs declared invalid because the obligations arising out of the their contractual framework were considered unequal from their onset.

Reference is also made to the recent decision of the Court of Appeal of Milan which, as described below, has significantly enriched the debate about IRSs and derivative contracts in general.

2. IRSs lacking the hedging purpose

The decision of the Court of Lucera dated 26 April 2012 falls squarely into the first group above. A limited liability company, in its capacity as borrower, entered into a credit agreement with a syndicate of banks. The credit agreement was secured by a number of security documents and the parties also agreed to enter into an IRS to provide the borrower with protection against the volatility of interest rates. Eventually, the drawdown of the financing did not happen but the protection sellers requested the payments due under the IRS. The Court emphasized the interplay between the credit agreement and the derivative contract and found that since the borrower never received the financing that was agreed with the syndicate of banks, the IRS lacked the hedging purpose (i.e. the cause) for which it was created. In other words, the credit agreement and the IRS were functionally correlated and once the financing did not go through, the IRS also ceased to take any effect.

Similarly, the Court of Florence, with its decision dated 5 June 2012, found that an IRS entered into to hedge the lessor against the fluctuation of payments due under a leasing contract had to terminate any of its effects since the leasing contract had also been terminated. This second decision confirmed that when a IRS is executed to pursue hedging strategies, that purpose needs to support the derivative contract for its entire life and it is not sufficient that it was there at the beginning of the contractual relationship.

3. IRSs unsuitable to achieve their purposes

The decision of the Court of Monza dated 17 July 2012 involves an IRS structured to achieve its “typical” purpose (i.e. entered into as commercial hedge) as follows:

- Maturity: 5 years (from 29 September 2003 to 29 September 2008);
- Date of payment of the fixed and floating rate interest amounts: on a three month basis from 29 December 2003;
- Notional amount: Euro 1,000,000.00;
- Fixed Rate Interest: 1 year: 2.20%; 2 year: 3.50%; 3 year: 4.30%; 4 year: 4.80%; and 5 year: 4.90%; and
- Floating Rate Interest: 3 month EURIBOR.

The expert instructed by the Court found that the IRS, though in principle a valid instrument to insure the borrower against unpredictable movements of interest rates, in practice proved to be totally inapt to achieve its functions. Indeed, starting from 2004 and for the successive three years, the floating rate interest was consistently and increasingly below the fixed rate interest agreed for each relevant period, with the borrower having to pay the negative difference for a total amount of Euro 35,480.37 in addition to the mark-to-market amount charged by the bank upon the early termination of the swap. In the expert’s view, the bank failed to provide an accurate assessment relating to the foreseeable fluctuation of interest rates even though it was their duty to do so, as also confirmed by a number of decisions and communications of the Consob (the Italian supervisory security authority). The expert expressly referred to the Consob communication n. 990013791 dated 26 February 1999 that sets out the conditions under which a derivative transaction is deemed to be entered into for hedging purposes. More specifically, to pursue hedging strategies:

- ✓ The derivative contract will have to be explicitly entered into by the protection buyer to hedge its exposure to the fluctuation of payments due under a credit agreement;
- ✓ the features of the derivative contract will have to reflect those set out under the credit agreement particularly in terms of maturity date and interest rates; and
- ✓ the internal risk audit of the protection seller will have to check and confirm that all the conditions above have been satisfied.

The Court of Monza confirmed the findings of the expert and declared that the IRS was null and void precisely because it was unsuitable to provide the protection (i.e. lacking the “cause”) for which it was (wrongly) designed.

The Court of Appeal of Trento recently followed the same reasoning and, with its decision dated 3 May 2013, came to the same conclusions reached by the Court of Monza.

4. IRSs unequal from the beginning

In its decision dated 12 April 2012, the Court of Orvieto goes on exploring how non-par IRS are structured and the fact that they are certainly admitted under Italian law. The Court referred to a Consob’s report dated 18 March 2009 in which non-par IRS were defined as those where the asset underlying the swap sells at a discount or a premium, i.e. at a non-market rate. The fixed rate is either above or below the prevailing swap rate and the non-par swap is used usually to hedge debt issues against changes in interest rates thereafter or in relation to the restructuring of debts arising out of IRSs that have been entered into before. However, the Consob’s report also confirmed that the financial terms of non-par structures had to be re-balanced with the payment of up-front fees in favour of the party that accepted the more penalising terms. In other words, it is fine to trade non-par IRS under Italian law provided in any event that the party that is “in the money” pays to the party that is “out of the money” an up-front fee, the intent of which is to make the difference of payment obligations at the start of the derivative contract equal to zero.

The Court went on analysing the financial conditions of each of the seven IRS that were entered into by a local municipality and found that for neither of them the payment of the agreed up-front fees managed to re-balance the inherent disparity of the non-par structures. The Court concluded that the IRSs were therefore affected by a sort of “genetic deficiency” and as such they had to be declared null and void.

5. The recent decision of the Court of Appeal of Milan

The Court of Appeal of Milan has recently joined the debate regarding IRSs and derivative contracts in general with their convincing decision dated 18 September 2013 n. 3459.

Once again, the dispute over which the judges of Milan had been called to decide regarded a number of IRSs entered into by a limited liability company with a bank to get protection against floating rate interest obligations. However, the Court of Appeal of Milan showed a different approach towards these types of disputes and affirmed that in order to determine whether a derivative contract is valid or not it is irrelevant the purpose for which that contract was entered into, i.e. whether it was designed to pursue speculative or hedging strategies. Additionally, for the judges of Milan, it was unconceivable that anyone would enter into a transaction without realising the quality and the quantity of the risks that business or agreement would entail. A derivative contract is no exception to this rule and therefore the risks assumed by the protection buyer must be identifiable and explicitly communicated by the bank or other financial institution to them, at the beginning of the relevant contractual relationship.

Putting it simply, in a derivative contract, the parties must assume any of the relevant obligation rationally and the banks and other financial institutions that sell these financial products will have to make sure that all the crucial financial and legal information are disclosed to and understood by their counterparts.

In applying such reasoning, the Court of Appeal of Milan went on touching a number of other critical issues concerning IRSs and derivative contracts in general. More particularly:

5.1 Hidden costs

As in a number of other courts' decisions, the Court of Appeal of Milan also found that hidden charges and confusion on costs of derivative contracts might have an impact on their validity and enforceability.

Providing correct and accurate information regarding costs of derivative transactions at the start of the transaction, it is not just a matter of transparency in selling financial services, it is an issue of validity of the investment itself, as costs are a measure of the risk run by the investors and they must be taken rationally.

Costs' opacity and the lack of clear, formal, easily discernible practice in determining their value will, in the Court of Appeal of Milan opinion, amount to the invalidity of the relevant derivative transactions.

5.2 Mark-to-Market

Strictly correlated with the issue of hidden costs is the mark-to-market factor of IRSs, i.e. a fee represented by the current market value of the swap that is requested by banks and other financial institutions when their counterparts request the early termination of the derivative contract.

Again, the decision of the Court of Appeal of Milan is rather conclusive on this significant point too.

As in other similar disputes that have been examined by Italian courts, the mark-to-market amount charged by the bank came as a (rather unpleasant) surprise for the investor. The fact itself that the investor was not aware of the amount of the mark-to-market upon the termination of the contract revealed that the IRS in question was entered into without the necessary consideration of the risks associated with it.

In relation to the mark-to-market factor of derivatives, other courts' decisions have condemned the methods of the relevant calculation which in most cases refer to market practices that are not easily discernible even for very sophisticated investors. Section 23, second paragraph, of the Italian Financial Act ("**IFA**") expressly prohibits the reference to such practices when they are utilised to determine the price of financial services and, when this happens in practice, not only it sanctions their invalidity but also provides that nothing will be due for the so mispriced financial instrument.

5.3 Section 21 of the IFA

Another very significant aspect of the decision of the Court of Appeal of Milan relates to the banks and other financial intermediaries' duty of care and information to the customers that invest in the financial services they provide.

The Court of Appeal of Milan confirmed that under Section 21 of the IFA, banks and other financial institutions will have to provide and disclose to their client all the information required to complete a financial transaction in the most efficient and rational manner.

In relation to IRSs and given the peculiarity of these derivative contracts, Section 21 of the IFA is applied even more rigorously than with the sale of other ordinary financial services. In selling IRSs, banks will be required to cooperate with and assist their clients in the investment choices they make, even when they haven't received a specific mandate to provide such services as their duty is inherent to the sale of risky financial services.

Banks will be under the obligation to pursue the best interest of their derivatives counterparts even when they will be dealing with professional investors. In such regard, the Court of Appeal of Milan confirmed that it is not acceptable for a bank or other financial intermediary to rely on the statement issued by the investor under Section 31 of the Consob Regulation n. 11522/98, i.e. the self-declaration confirming that they are professional investors. Banks and other financial players will have to verify that capacity in practice and even then they will be subject to the duty of care and information towards their customers, whether professional investors or otherwise.

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The decision of the Court of Appeal of Milan somewhat supplemented and absorbed all the findings of the other judgments mentioned above. The IRSs that came under their scrutiny were declared invalid because they lacked the essential element that any derivative contract, in their view, should contain: clear and easily ascertainable risk factors that investors would rationally assess before executing the relevant contract.

6. Conclusions

The market for IRSs in Italy has seen numerous setbacks over the past years and it is still facing a dubious future. However, the fervent debate among legal scholars and courts of law regarding these derivative contracts will probably help banks and other financial intermediaries to put into action improved compliance protocols. The recent decision of the Court of Appeal of Milan seems to be extremely helpful in such regard: it won't matter if the bank's client, counterpart in a derivative transaction, is pursuing an hedging or speculative strategy as the duty of care and information imposed by Section 21 of the IFA will apply irrespectively. In addition, the carve-out for professional investors provided by Section 31 of the Consob Regulation n. 11522/98 will not apply when banks are selling IRSs and other equally sophisticated derivative contracts.

Banks and other financial intermediaries will have to cooperate with their customers to ensure that all the risks involved in their financial products are fairly and clearly disclosed to them, including in relation to costs, mark-to-market to effect the early close-out and all the relevant risk factors that would enable an investor to make a balanced investment decision.

Finally, when the hedging strategy of an IRS is expressly provided in the contract, banks and other protection sellers will have to ensure that the derivative transaction that they have created for their clients is in fact suitable to achieve that purpose at the beginning and for the entire life of the derivative transaction.

7. Table of cases

Court of *Orvieto*: judgment dated 12 April 2012 in http://www.ilcaso.it/giurisprudenza/archivio/7314.php

Court of *Lucera*: judgment dated 26 April 2012 in http://www.ilcaso.it/giurisprudenza/archivio/7684.php

Court of Florence: judgment dated 5 June 2012 in http://www.ilcaso.it/giurisprudenza/archivio/7344.php

Court of *Monza*: judgment dated 17 July 2012 in http://www.ilcaso.it/giurisprudenza/archivio/7771.php

Court of Appeal of *Trento*: judgment dated 3 May 2013 n. 141 in http://www.ilsole24ore.com/pdf2010/SoleOnLine5/_Oggetti_Correlati/Documenti/Finanza%20e%20Mercati/2013/06/Sentenza-46_2012-Tribunale-Trento.pdf

Court of Appeal of Milan: judgment dated 18 September 2013 n. 3459 in http://www.ilcaso.it/giurisprudenza/archivio/9487.pdf