

# The Italian Council of State rules on local authorities' powers to annul derivative contracts

*In a case concerning derivative transactions entered into between the Italian Province of Pisa and certain credit institutions, the Council of State (Italy's highest ranking court for administrative litigation - decision no. 05032/2011 filed on 7 September 2011) ruled that Italian administrative courts have jurisdiction over the legitimacy of the administrative annulment by a local authority of its own decision to enter into derivative contracts, and over the consequences of such annulment on the validity of the relevant contracts.*

*According to the Council of State, the jurisdiction of the Italian (administrative) courts must be upheld notwithstanding the jurisdiction clause in the ISDA Master Agreement governing the transactions and prior legal proceedings on the same transactions pending before the courts of the jurisdiction stipulated in the agreement.*

*The Council of State further ruled that a local authority may, subject to certain conditions, unilaterally revoke its decision to enter into a derivative transaction if any irregularities are found to have affected the administrative process resulting in the decision; where the decision to enter into a derivative transaction has been lawfully revoked, then the transaction must be deemed (retroactively) unenforceable.*

## The case

In 2007 the Province of Pisa refinanced its pre-existing bank debt by issuing a EUR 95.5 million bond issue arranged by two international credit institutions appointed through an informal auction process. In order to hedge the interest rate risk under the bonds, the Province of Pisa also entered into an interest rate swap with each of the arrangers.

Subsequently, in the year 2009, the Province of Pisa used its statutory "self protection" powers (*autotutela*) to annul its decision to appoint the two banks as the arrangers of the bond issue and to enter into the hedging transactions with them. This was justified, according to the Province of Pisa, because it had since become aware that the swaps carried undisclosed "implicit costs" in the form of negative mark to market for the Province at inception. This had made the bond issue more expensive for the Province than its pre-existing indebtedness, which constituted a breach of the Italian law requirement, as set forth under Article 41 of Law no. 448 of 28 December 2001, that local authorities only refinance their indebtedness if there is "economic convenience" in doing so.

The Province also argued that, because the swaps had been entered into on the basis of the annulled decision, the swaps were unenforceable from the beginning. On these grounds, the Province suspended its payments under the swaps.

## Key Issues

### The case

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### The Council of State's ruling

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### Consequences

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The banks challenged the legitimacy of the annulment before the Regional Administrative Court of Tuscany. The Court confirmed that the annulment was legitimate, but ruled that civil courts, as opposed to administrative courts, would have jurisdiction over the consequences of the annulment on the contracts. This decision was subsequently appealed before the Council of State by both the banks and the Province of Pisa.

### The Council of State's ruling

The appeal was heard before the Council of State on 17 May 2011; following the hearing, on 7 September 2011 the Council of State filed its decision no. 05032/2011 to the following effect:

- Italian administrative courts, rather than civil courts, have jurisdiction (a) as to whether the annulment in self-protection by a local authority of its own decision constitutes a lawful use of its self-protection powers, and (b) as to the consequences of such annulment on the contracts entered into on the basis of the annulled decision;
- According to the Council of State, Italian administrative courts have jurisdiction on the impact of the annulment of a local authority's decision on the contracts entered into as a result of such decision, even if the contracts provide for the exclusive jurisdiction of a non-Italian judge (such as Section 13 of the ISDA Master Agreement providing for the exclusive jurisdiction of the English courts). This is because, in the Council of State's view, the subject of the dispute is one that the parties are not free to dispose of contractually, as it is primarily concerned with the appropriate exercise of administrative powers - in the pursuit of a public interest - that ultimately led to the execution of the contract, rather than the performance or interpretation of the contract itself;
- If a local authority acts within a reasonable timeframe (which could be as long as two years after the conclusion of the contract), and in pursuit of an appreciable public interest, it cannot be deemed to have waived its self-protection powers to unilaterally annul its decision to enter into a contract;
- If a local authority lawfully annuls its decision to enter into a contract, the contract itself would be deemed unenforceable (retroactively) because its execution was based on the annulled decision. The Council of State deemed that further technical analysis was required to assess whether, in the case at hand, the decision of the Province of Pisa to enter into the contract had indeed been affected by any irregularities, which would enable the Province of Pisa to action the self-protection remedy; however, the Council of State indicated that if, following such technical analysis, the Province of Pisa was actually entitled to annul its decision to enter into the contract, then the annulment would result in the (retroactive) unenforceability of the swaps.

In this context, it is worth noting that - in the Council of State's view - the mere existence of "implicit costs" associated, according to the Province of Pisa, with the swaps, appears to be *per se* capable of giving rise to irregularities in the administrative process leading to the selection of the contractual counterparties and, ultimately, to the conclusion of the contracts with them. This is because, taking into account also the "implicit costs" (in the form of negative mark to market), the bond issue resulting from the restructuring of the pre-existing indebtedness would become more onerous than the position prior to the restructuring, which would be in breach of the "economic convenience" test.

The Council of State's decision seems to imply that the mere fact that the test was failed (due to the existence of implicit costs) provides sufficient grounds for the annulment of the Province's decision to enter into the swaps, regardless of (i) whether or not the implicit costs should have been disclosed to the Province of Pisa, in accordance with applicable business conduct rules, or (ii) whether or not implicit costs were excessive. These issues (which lie at the core of the debate in other litigations pending before civil courts) seem to bear little relevance to the discussion on whether the annulment of the Province's decision to enter into the swaps was lawful. Rather, the Council of State appears to consider these issues only to determine whether the annulment was made within a "reasonable timeframe" from the stipulation of the swaps, on the grounds that the Province should be entitled to a longer period of time during which to annul its decision if the swap counterparties were found to have breached the business rules of conduct.

### Consequences

The decision of the Council of State is expected to turn up the heat on the already lively debate over the use of derivatives by Italian local authorities over the past few years.

With many litigation proceedings pending, and many more threatened, it is possible that the Council of State decision will encourage local authorities to follow the example of the Province of Pisa and opt for the unilateral annulment, by way of "self protection", of their decisions to stipulate the derivative contracts, rather than having to commence litigation before the civil courts: a much speedier and convenient route to reach the same result.

Once the local authorities will have unilaterally set aside the derivative contracts with their counterparties - by revoking their own decisions to enter into such derivatives - it will be up to the counterparty to challenge the annulment before a

court, and, according to the Council of State, the legal proceedings would have to be brought before the *Italian* (administrative) courts, notwithstanding any jurisdiction clause in the contract.

This may not be the end of it, however. Because it rules on matters of jurisdiction, the Council of State decision can be appealed before the Supreme Court of Cassation, which has often endorsed different views, holding that civil courts, as opposed to administrative courts, should claim jurisdiction on the validity of contracts concluded by local authorities.

Besides, foreign courts stipulated to have jurisdiction in accordance the jurisdiction clauses in the ISDA Master Agreement may take a stance against the position of the Council of State, leveraging on Council Regulation (EC) No 44/2001 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters, as subsequently amended.

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