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Briefing note

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Derivatives with Italian local authorities: Council of State rules against the Province of Pisa

In its decision no. 5032/2011 of 7 September 2011, the Council of State had ruled that a local authority could, subject to certain conditions, unilaterally revoke its decision to enter into certain derivative transactions, thus retroactively setting aside the transactions. The assessment whether the conditions for the unilateral annulment had been met in the case which was the subject matter of the judgment (about derivative transactions entered into between the Italian Province of Pisa and certain credit institutions) had been deferred to a subsequent decision of the Council, to be made with the benefit of technical analysis by court-appointed experts. Whether or not the transactions in question embedded any 'implicit costs' – on which the court-appointed experts would need to opine – appeared to be the critical issue.

This decision has now been handed down (Council of State's decision no. 5962/2012 of 27 November 2012), the Council of State ruling that the Province of Pisa was not entitled to unilaterally revoke its resolution in the specific circumstances, notwithstanding that the transaction did in fact bear implicit costs in the experts' view.

Contacts

Avv. Lucio Bonavitacola
Partner Finance & CM
lucio.bonavitacola@cliffordchance.com

Avv. Riccardo Coassin
Associate Finance & CM
riccardo.coassin@cliffordchance.com

Avv. Francesca Imbriani
Finance and DCM Knowledge Management Lawyer
francesca.imbriani@cliffordchance.com

The case

In the year 2009, the Province of Pisa used its statutory "self-protection" powers (*autotutela*) to annul its decision to enter into certain swap transactions with two credit institutions in connection with a bond issued by the Province in 2007 to refinance pre-existing debt. The annulment was carried out on the grounds that the swaps carried undisclosed "implicit costs" (in the form of negative mark- to- market), which made the bond issue more expensive than its pre-existing indebtedness, in breach of the Italian law requirement that local authorities may only refinance their indebtedness if there is "economic convenience" in doing so.

The annulment was challenged by the two banks before the Regional Administrative Court of Tuscany and subsequently appealed before the Council of State.

In its decision no. 5032/2011 of 7 September 2011, the Council of State had ruled that, should the bond issue (together with the swaps) be found to lack economic convenience, the Province of Pisa could be deemed to have lawfully exercised its powers unilaterally to revoke its decision to enter into the transactions, thus retroactively setting aside the transactions; court-appointed experts were mandated to assess whether, in the circumstances, the bond issue could be regarded as an economically convenient transaction for the Province of Pisa.

The new ruling

With the benefit of the experts' analysis, on 27 November 2012 the Council of State handed down its decision no. 5962/2012, ruling as follows:

– Financial institutions entering into derivative transactions with their clients must be able to charge, on top of the then mark-to-market of the transaction, certain amounts on account of costs (e.g. funding costs) or risks (e.g. credit risk) that they will incur as a result. In addition to such amounts (on account of costs or risks) a financial institution executing a derivative trade with a client would charge an amount which is intended to remunerate the financial institution. Only this latter amount (the sheer remuneration) – where charged by properly adjusting the terms of the parties' mutual obligations to make periodic payments under a swap, rather than by charging a bespoke amount upfront – may be regarded as an "implicit cost";

– On this basis, the implicit costs of the trades with the Province (originally determined in ca. EUR 1,300.000) were re-calculated as amounting to approximately EUR 320,000;

– Consequently, the bond issue, coupled with the swaps which were the subject matter of the dispute, could be deemed "economically convenient" for the Province, which by issuing the bonds and entering into the related swaps would be better off than it was under the pre-existing indebtedness. Indeed, the losses which had been averted by the Province by extinguishing the pre-existing indebtedness were greater than the "implicit costs" of the swaps, as re-calculated, entered into as part of the restructuring;

– The banks, counterparties to the Province, had no duty to disclose the implicit costs under the then applicable regulatory framework, in light, amongst other things, of the fact that the Province had selected them through an auction process.

Consequences

The newly issued decision of the Council of State is likely to "cool down", at least to some degree, the excitement that the previous judgment had fostered among local authorities seeking to free themselves from onerous derivative contracts. While the principle still stands that local authorities may, in some circumstances, unilaterally annul their resolutions to enter into derivative contracts, in practice this is subject to a severe test around absence of economic convenience, which the Council of State has shown to be a very difficult one to meet.