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Swaps and insolvency: the Supreme Court throws a spanner in the works

On 18 November 2015 the Spanish Supreme Court has ruled out the possibility of relying upon the special regime established in Royal Decree-Law 5/2005, from 11 March ("RDL 5/2005") for protecting swap debt in an insolvency, going back to the doctrine of the Barcelona Court of Appeal, which declared that a netting arrangement requires several transactions under the cover of a master agreement.

I. RDL 5/2005, as special legislation displacing the Insolvency Law

RDL 5/2005 has the effect of displacing the insolvency regime from governing claims arising from derivatives contracts, as regards the treatment of the debt and the termination.

The application of the special legislation assumes that one of the parties is a financial entity (or another such entity as defined by that legislation) and applies "to financial transactions carried out within the framework of a master arrangement or in relation thereto, provided that the arrangement foresees the creation of a single legal obligation encompassing all transactions included in said arrangement, and by virtue of which, in the case of an event of early termination, the parties will only be entitled to claim the net balance of the product of the liquidation of those transactions".

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II. Article Sixteen of RDL 5/2005

Article Sixteen of RDL 5/2005 relates to the early termination of the master agreement and makes reference to the treatment, in insolvency proceedings, of the debt resulting from the swap. It also limits claw back actions.

The wording of this article has been amended a number of times.

The original wording only stated that in insolvency, upon termination of the swap, the resulting balance would be a claim or a debt in the insolvency. In 2011, it was amended to clarify that, insofar as the arrangement remains in force following the declaration of insolvency, the regime governing agreements with reciprocal obligations under the Insolvency Act will apply. And, if the arrangement is terminated

following the insolvency, the Insolvency Act will apply: the treatment of the debt will depend on when the early termination event occurs: if it is due to a breach by the insolvent party prior to the declaration of insolvency, or as a result of the insolvency declaration itself (the law considers this case to be equivalent to the previous one), this will create a pre-insolvency debt. If the event triggering the early termination occurred afterwards, then the debt will be against the insolvency estate (i.e., payable as an expense of the estate before the pre-insolvency claims).

Hedge agreements remaining in force after the declaration of insolvency are treated as if they were agreements which generate reciprocal obligations. The successive sums due under those agreements payable by the debtor will be debts against the insolvency estate. Agreements can also be terminated in the best interest of the insolvency estate; in that case, the resulting amount will be a debt against the insolvency estate.

In 2011 the legislator amended RDL 5/2005 to apply to swap master agreements the insolvency regime on agreements with reciprocal obligations pending by both parties. Legal opinion was then divided between those who understood that the legislator had merely reaffirmed the matter, and those who understood that the reform changed how swaps were treated. In any event, the reality is that, since 2011, RDL 5/2005 applies the same legal regime to swaps as does the Insolvency Act when it refers to agreements with pending reciprocal obligations by both parties.

III. Spanish case law on swap debt

The Supreme Court had issued several judgments based on the pre-2011 wording of Article Sixteen. This case law applied the general regime of the Insolvency Act, and held that a master agreement does not generate reciprocal obligations for the parties: therefore, any debts arising from a swap which remain in force following the declaration of insolvency would always be pre-insolvency debts.

The doctrine of the Supreme Court is set out in Judgments dated 8 and 9 January 2013. They understood that swaps give rise to only one single obligation, to be paid by one party or the other. If these contracts are not considered agreements having reciprocal obligations under the Insolvency Act, then their treatment in insolvency would be similar to that of a loan: generally speaking, the hedge provider would simply have a pre-insolvency claim.

The Barcelona Court of Appeal had added an argument which enabled most swaps to be situated outside the scope of RDL 5/2005, construing that a swap can only be referred to as a master netting arrangement when several transactions exist, under the cover of a framework agreement, in which settlements can be offset against each other.

This reason was stated in (among others) its Judgment of 14 May 2013: "We understand that the existence of several financial transactions is a key structural requirement in order to be able to apply the rules regarding master netting arrangements. The netting mentioned in Article 5 of RDL 5/2005 does not refer to the netting of balances or internally within the same swap transaction, but rather the netting of different transactions against each other".

However, the Supreme Court expressly dismissed the view of there being one single transaction, in its Judgment of 2 September 2014 (with one dissenting opinion): at that time, the Supreme Court stated that the view that arrangements regarding a sole financial transaction cannot be considered master netting arrangements "does not seem appropriate, according to a purposive interpretation of the rule set forth in Article 5 of RDL 5/2005, since it applies whenever the transaction targeted by the arrangement - even if it is the sole transaction - generates obligations for the two parties which may be offset". And the Court added that this conclusion is supported by the current wording of RDL 5/2005, which refers to the net amount of the "transaction or transactions" targeted by the master netting arrangement.

In any event, while still applying the pre-2011 wording of RDL 5/2005, the Court continued to consider that swaps did not generate reciprocal obligations: "there is no doubt that said agreement creates obligations for the two parties, but this does not suffice to consider them reciprocal, in the sense indicated, since – despite the fact that they are usually called 'swaps' – the payments due by each of the parties to the agreement do not constitute consideration for what is due by the other party, which may never become due".

IV. The current situation

Since 2011, RDL 5/2005 unmistakably establishes that swaps are to be treated as agreements having reciprocal obligations, with express reference made to the Insolvency Act. This has consequences both in terms of the termination of the master agreement, as well as the treatment in insolvency of the debt resulting from a contract which remains in force.

Regarding this latter aspect, to the extent that RDL 5/2005 applies, it would not be possible to avoid the fact that the debt resulting from the swap is a debt against the insolvency estate.

Two judgments of the Madrid Court of Appeal were along these lines: those of 4 and 18 May 2015. Based on what the Supreme Court had stated in its Judgment of 2 September 2014, cited above (dismissing the view regarding the sole transaction), they concluded that the contracts remaining in force after the declaration of insolvency generate debts against the insolvency estate.

V. The Judgment of 18 November 2015

On the basis that the current wording of RDL 5/2005 would inevitably lead to an increase in debts against the insolvency estate, the Supreme Court has revisited the Barcelona Court of Appeal's theory, according to which a sole transaction would not fall within the scope of RDL 5/2005.

It should be noted that the recent Judgment does not seem to apply the current wording of Article Sixteen of RDL 5/2005 (since the facts it considered, occurred prior to its entry into force). Therefore, it is possible that the opinion deriving from this Judgment may be distinguished in relation to any future decisions which consider the new wording.

It is also important to bear in mind that the Judgment only deals with the insolvency regime on a debt resulting from a swap which remains in force following the declaration of insolvency. We cannot assume, therefore, that the Court would also exclude the "sole transaction" from the regime in RDL 5/2005, when what is being judged is its termination following a declaration of insolvency.

At any rate, it is surprising that the Court has changed its opinion from its early decision on 2 September 2014, without so much as explaining why. In short, the Supreme Court seems to be throwing a spanner in the works again for the legislator. In light of the successive reforms of Article Sixteen, designed to apply the regime governing debts against the insolvency estate to master agreements, the Supreme Court insists on situating these contracts (those involving just one single transaction, for the purpose of classifying the credits deriving in the future) outside the scope of application of RDL 5/2005.

It is not the first time a judicial interpretation has endeavoured to preserve the insolvency estate, avoiding the acknowledgement of a debt against the insolvency estate, even though the legal grounds for doing so may be questionable.

As this latest decision demonstrates, the gap between what the legislation says and the view of the Supreme Court makes the case for further legislative intervention an absolute necessity; one which will clarify, once and for all, which regime applies to swaps in the event of insolvency.

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