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Briefing note

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"Snowball" swaps enforced

The English court has decided that "snowball" swaps entered into by Portuguese public transport entities with a Portuguese bank but governed by English law can be enforced. The fact that the swaps were subject to ISDA's Master Agreement was a key part of the court's conclusion that Portuguese mandatory laws could not override the English governing law chosen by the parties.

Key issues

- The needs of certainty in financial transactions emphasised
- The international market and standard documentation guarantees the parties' choice of law prevails over local law

Disputes between banks and public authorities over interest rate swaps are not new. English, Italian, Norwegian and German public authorities are among those that have come before the English courts to argue that they are not bound by swaps that have turned out to be expensive. The public authorities' success rate has been variable. The most recent case in this line, *Banco Santander Totta SA v Companhia de Carris de Ferro de Lisboa SA* [2016] EWHC 465 (Comm), involved an unsuccessful attempt by Portuguese transport authorities to avoid the financial consequences of swaps characterised as "exotic" because of their "memory" and leverage features.

Banco Santander Totta concerned nine long-term swaps entered into between 2005 and 2007 by a bank and the five authorities that run public transport in Lisbon and Porto. The swaps varied in their terms, but taking one swap as an example:

- The swap had a notional principal of €90m, which amortised to €1.67m over its 12½ year term. This amortisation profile followed that on loan agreements entered into by the authority with the EIB.
- The bank paid the floating rate of six month EURIBOR.
- The authorities paid the fixed rate. The fixed rate for any period was the fixed rate for the previous period plus 3.5 times the extent to which EURIBOR was either below 2.75% or above 6%.
- The memory feature, ie the fixed rate being calculated as the last fixed rate plus the new fixed rate, has led to very high fixed rates because of the unprecedentedly low interest rates since early 2009. This effect has been exacerbated by the multiplier (hence the name "snowball" swap).
- The fixed rate was reset in 2011 (other swaps included terms that reduced the fixed rate if the floating rate fell within the upper and lower bounds).
- The swaps were governed by English law and subject to the ISDA Master Agreement.

The authorities entered into the swaps not as direct hedges but as part of their financial management aimed at reducing their overall interest burden. The finance departments in the authorities were not sophisticated but had an adequate level of expertise. The formulae for fixed rates in the confirmations were, in Blair J's view, hard to understand when first read, but straightforward once understood, and the authorities did in fact understand how the fixed rates were calculated.

The swaps provided attractive initial rates, well below the rates obtainable on "vanilla" interest rate swaps, but the price of those low fixed rates was the "very, very aggressive risk profile" entailed by the memory and leverage features if interest rates went outside the barriers in the swap.

At first, the swaps were successful in achieving the authorities' aim. The expert evidence was that, viewed at the time the swaps were entered into, there was a 72% chance that the swaps would prove beneficial to the authorities over the swaps' lives. However, none of the parties could or did foresee the effect of the global financial crisis.

The authorities did not argue that they had been missold the swaps or that the bank had breached any advisory duty. The authorities' arguments as to why they were not bound by the swaps turned on Portuguese law rather than English law. The authorities argued that they had no capacity to enter into the swaps, that the swaps breached Portuguese mandatory law and that, in selling the swaps, the bank had acted in breach of Portuguese Securities Code.

The judge rejected the argument that the swaps were outside the authorities' capacity under Portuguese law. He also rejected the contention that the bank had broken Portuguese securities law.

The argument about Portuguese mandatory law turned on article 3(3) of the Rome Convention on the law applicable to contractual relations (now article 3(3) of the Rome I Regulation). This provides that if the parties agree that a contract is to be governed by a particular law (here, English law) but "all other elements relevant to the situation at the time of the choice are connected with one country only, [the parties' choice of law does not] prejudice the application of rules of the law of that country which cannot be derogated from by contract". The authorities argued that they were Portuguese, the bank was Portuguese and performance was to take place in Portugal; article 3(3) therefore applied; and the swaps were unenforceable as a result of Portuguese mandatory laws relating to games of chance and abnormal change of circumstances.

Blair J rejected the argument that article 3(3) applied to the facts of this case. He considered that any factors that pointed away from a purely domestic to an international situation were relevant for these purposes.

Disagreeing with the earlier decision in *Dexia Crediop Spa v Commune di Prato* [2015] EWHC 1746 (Comm), he concluded that the use of ISDA and other standard documentation used internationally was relevant to this. Overall, he considered that the express right given to the bank to assign its rights to a bank outside Portugal, the use of standard international documentation, the practical necessity for the bank to use the services of its parent in Spain, the international nature of the swaps market in which the swaps were concluded and the back to back contracts entered into by the bank with non-Portuguese banks were enough to exclude article 3(3).

However, if the judge had decided that article 3(3) was applicable, he would have concluded that the swaps were not games of chance within the meaning of Portuguese law. He would have decided that the global financial crisis was an abnormal change of circumstances under Portuguese law, but that Portuguese law in this area could be derogated from by contract, even if only after the event. Article 3(3) did not, therefore, allow Portuguese law to override English law.

The swaps were therefore enforceable by the bank.

Conclusion

The decision in *Banco Santander Totta* was given in the English courts' new Financial List. As might be expected, this court was clear that if the parties have chosen an international form of agreement governed by English law, it will take very strong factors to persuade the court to allow any other law to override the terms of the contract. The needs of certainty in international finance point firmly to courts' upholding the parties' choice in all but exceptional circumstances.

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