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SWAPS IN THE PORTUGUESE COURTS

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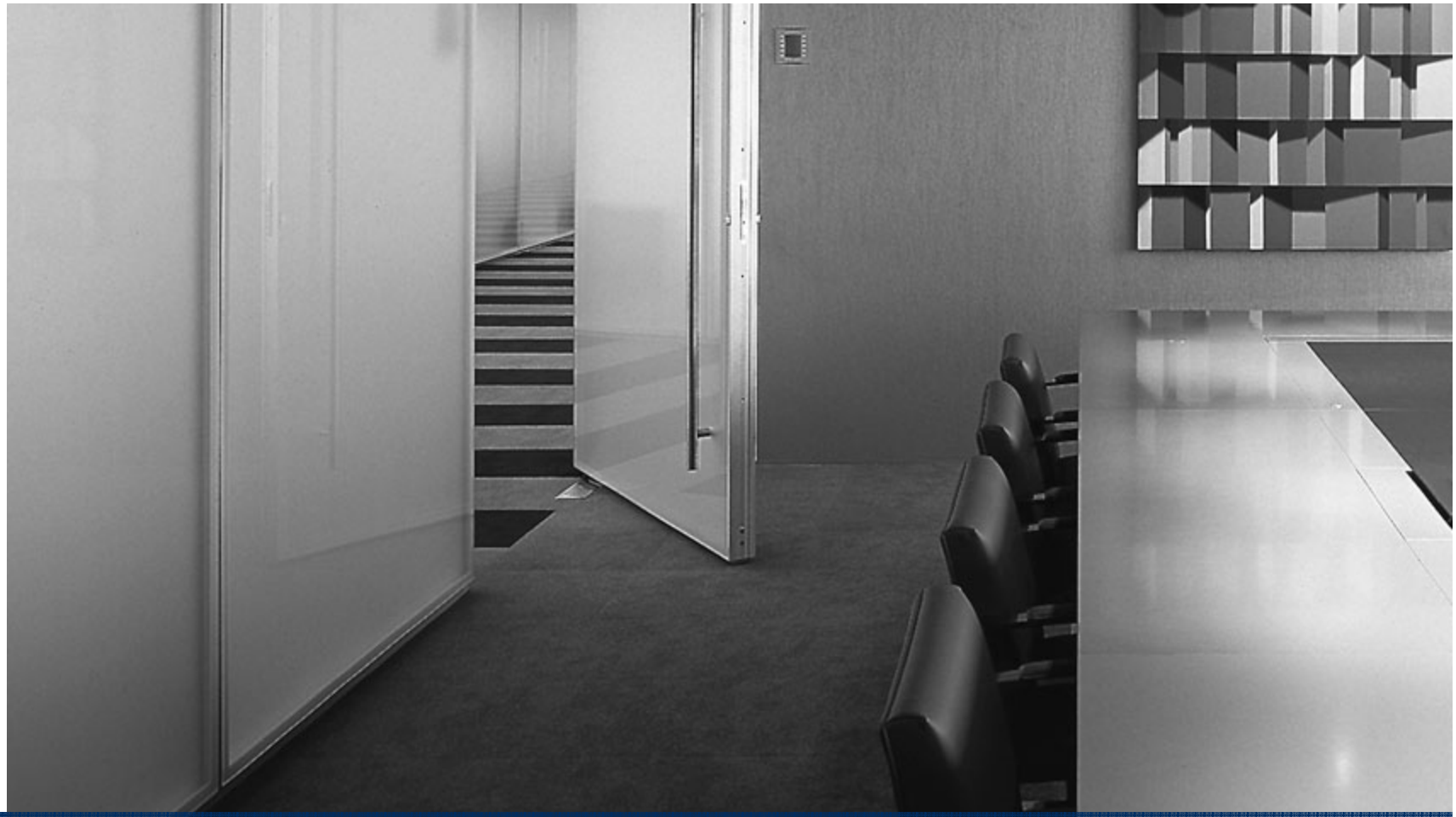
Swaps in Portugal



Swaps in Portugal

Background

- Following the sharp downfall of interest rates in late 2008 and the impact of the same on swap transactions, many clients have challenged the validity of swap agreements executed with several banks.

- Swap agreements were fairly unknown to the Portuguese Courts, which, in consequence, have rendered several different and contradicting decisions.

Swaps in Portugal

Background

Publicly owned companies

- In December 2012, Portuguese publicly owned companies had 113 swaps agreements in force with several banks, with potential losses of 3.1 billion Euros.
- Since then, the Portuguese state has reached an agreement with nine banks to terminate, at least, 69 contracts: Barclays, Société Générale, Nomura, Credit Suisse, Goldman Sachs, Morgan Stanley, BNP Paribas, JP Morgan and Deutsche Bank.
- With regard to the remaining agreements, the publicly owned companies have:
  - stopped complying with the payments due under the swap agreements; and/or,
  - challenged their validity in Court.

Swaps in Portugal

Background

Publicly owned companies

- There are currently 5 proceedings pending before the English High Court of Justice – Queen's Bench Division – Commercial Court, filed by a local bank, with regard to the following companies:
  - Metropolitano de Lisboa (Lisbon Metropolitan);
  - Carris (Public Transport of Lisbon);
  - STCP (Public Transport of Oporto);
  - Metro do Porto (Oporto Metropolitan) (two proceedings).

Swaps in Portugal

Background

Publicly owner companies

- The bank filed these proceedings requesting that the Court recognizes the validity of the swap agreements and that the companies should be obliged to comply with the same.

- The companies have replied, claiming that:
  - they did not have the legal capacity to execute the agreements;
  - the swap agreements are speculative;
  - there was an abnormal change of circumstances; and
  - the bank has not complied with legal requirements.

Swaps in Portugal

Background

Private sector companies

- Since late 2008, many private sector companies brought proceedings against several banks in view of challenging the validity of swap agreements executed with the same.
- Portuguese courts have not been unanimous in their decisions.

How the Portuguese courts look at swaps

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Main issues

Jurisdiction and applicable law

- Validity of foreign jurisdiction clauses
- Validity of arbitral clauses

Abnormal change in circumstances

- Termination of swap agreements in light of a change of circumstances caused by the financial crisis

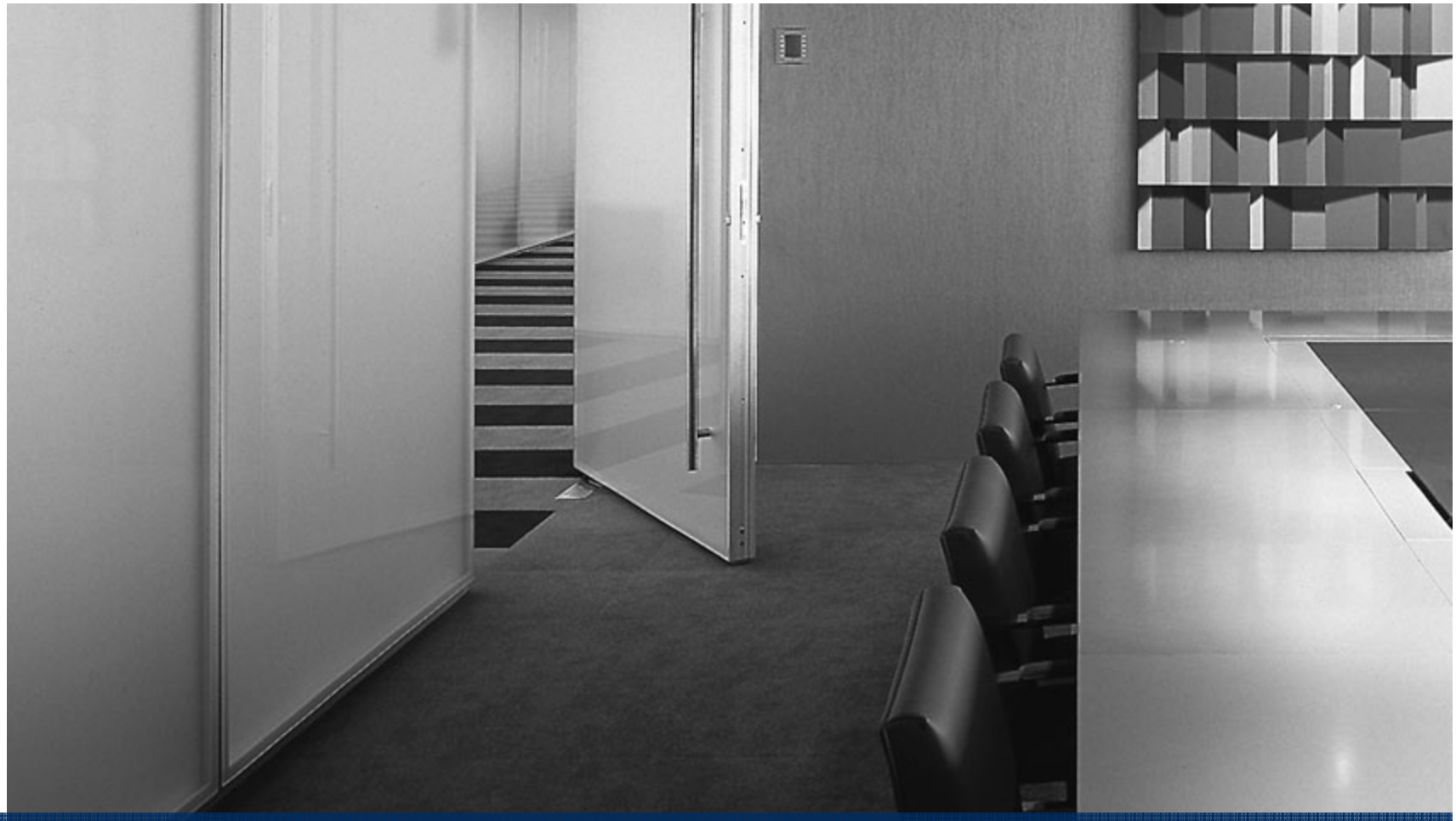
Illegal games of chance

- Invalidity of swap agreements due to their qualification as games of chance

Violation of public order

- Invalidity of swap agreements due to offense to public order

Jurisdiction and applicable law



How the Portuguese courts look at swaps

Jurisdiction and applicable law

Publicly owned companies

- At least five publicly owned companies of Madeira have filed proceedings against banks in Portugal, claiming the invalidity of the swap agreements executed with the same:
  - Sociedade Metropolitano de Desenvolvimento;
  - Madeira Parques Empresariais;
  - Ponta do Oeste;
  - Sociedade de Desenvlvimento do Porto Santo;
  - Sociedade de Desenvolvimento do Note da Madeira.

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Publicly owner companies

- The swap agreements in question are subject to ISDA Master agreements executed by the parties, which contain the following jurisdiction clause:

"Governing Law and Jurisdiction

(a) Governing Law. This Agreement will be governed by and construed in accordance with the law specified in the Schedule.

(b) (...) Jurisdiction. With respect to any suit, action or proceedings relating to this Agreement (Proceedings), each party irrevocably:-

(i)Submits to the jurisdiction of the English courts, if this Agreement is expressed to be governed by English law (...)."

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Public sector companies

- The publicly owned companies claim that said jurisdiction clauses are not valid, considering that:
  - Regulation (EC) 44/2001 is inapplicable (due to lack of elements of internationality) and the clauses are invalid in light of Portuguese law; and
  - they are null and void due to the application of the Portuguese General Contractual Terms legislation, as it causes serious difficulties for the companies.

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Public sector companies

- Two Portuguese Courts have so far ruled that the jurisdiction clauses included in the ISDA Master agreements are valid, both in light of Regulation (EC) 44/2001, and of Portuguese internal law, on the following grounds:
  - they are international contracts linked to more than one legal system, thus, the provisions of the EC regulation are applicable, which prevails over national law; and
  - The companies imposed that the agreements be subject to the ISDA Master Agreement, they are qualified investors and were legally advised on the matter. Therefore, invoking the invalidity of the jurisdiction clause - which they proposed, even if they did not draft - is a breach of good faith.

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Private sector companies

Foreign jurisdiction clauses

- Swap agreements executed with private sector companies more commonly have arbitration clauses rather than foreign jurisdiction clauses.

- Nonetheless, in at least one known case, contrary to the referred rulings regarding publicly owned companies, a Portuguese Court ruled that a jurisdiction clause, which imposed that the swap agreement be governed by English law and subject to the jurisdiction of English courts, was invalid (decision of the Court of Appeal of Lisbon, 10.4.2014, proceedings no. 877/127TVLSB.L1-1).

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Private sector companies

"*A clause that results from a standard master agreement, which established, with exclusivity, as competent, the courts of a country in which are the headquarters of one of the parties (in case, the Bank), despite having a permanent representation in Portugal, and just because the contract is subject to English law, the counterparty being a Portuguese company, based in Portugal, creates serious disadvantages for this part, given the distance it is from the elected forum, creating inevitable litigation difficulties without a justified and prevailing interest in this for this option.*

(...)

Litigating against a bank with its headquarters in said foreign country - considering the distance of the headquarters of the company in relation to the forum established in a foreign country (U.K.), which has a legal system diametrically opposed to Portugal's -, creates serious difficulties".

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Private sector companies

Arbitration clause

- Many swap agreements executed with private sector companies include an arbitration clause, subjecting any litigation to the jurisdiction of an arbitration court.
- The validity of said clauses have also been challenged in judicial courts.
- Rulings have been fairly unanimous in this regard, with Portuguese Courts declaring themselves incompetent to rule on this matter, due to the "Kompetenz-Kompetenz" principle, which grants arbitration courts the ability to rule on their own competence (as set forth in article 15 of the Portuguese Arbitration Law).

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Private sector companies

- Although in 2012, the Court of Appeal of Guimarães decided not to apply the arbitration clause (considering that the issues in question were not subject to the same), banks have been very successful in dismissing judicial cases based on the competence of the arbitration courts.
- This was the case, for example in the decision of the Court of Appeal of Lisbon dated 11.12.2014, proceedings no. 2040/13.0TVLSB.L1 and decision of the same court, dated 4.12.2014, proceedings no. 1770/13.1TVLSB.L1.
- In both cases, the companies claimed that the arbitration clauses were not valid, as they were included in the master agreement, which terms were not negotiated.

How the Portuguese courts look at swaps

Jurisdiction and applicable law

Private sector companies

- In accordance wih the "Kompetenz-Kompetenz" principle, the Courts decided that :

  "*When a matter of competence of the arbitration court is at stake, it is up to the arbitration courts to decide on the validity of the arbitration clause and, consequently, on its own competence. This rule is only excepted if and when the arbitration clause is manifestly void, unfeasible or ineffective. This will only occur when the judge, without the necessity of a deep analysis, can immediately detect the nullity, ineffectiveness or unfeasibility of said arbitration clause, without the need for any supporting evidence*".

How the Portuguese courts look at swaps

Jurisdiction and applicable law	
Private sector companies	"*The mere obstacle to the litigation in an arbitration court, such as distance or constraints relating to having to transfer witnesses and lawyers from one part of a country to another is not a case of unfeasibility of the arbitration clause, but solely a difficultas praestandi (difficulty to perform). Hence, the matter of competence of the arbitration court should be ruled by the arbitration court itself*".

Abnormal change in circumstances

How the Portuguese courts look at swaps

Abnormal change in circumstances

- Article 437 of the Portuguese Civil Code establishes that:

"If the circumstances on which the parties based their decision to enter into a contract have undergone an abnormal change, the injured party is entitled to request the termination of the contract or its modification in accordance with the principles of fairness if the fulfilment of that party's obligations under the contract would constitute a serious breach of the principles of good faith and the abnormal changes do not form part of the risks covered by the contract".

How the Portuguese courts look at swaps

Abnormal change in circumstances

- The downfall of the interest rates in the late 2008 led many companies to challenge their swap agreements, considering there had been an abnormal change of the circumstances based on which they had executed said agreements.

- It is argued that, when entering into the swap agreements, it was expected, by all of the market participants, that the interest rates would continue to rise, as had been the tendency until 2008.

- Thus, the circumstances based on which the parties executed the agreements – the expected rise of the interest rates – have changed.

How the Portuguese courts look at swaps

Abnormal change in circumstances

- Rulings on this matter have not always been unanimous, with the first decision on the matter from the Portuguese Supreme Court considering that the abrupt fall of the interest rate constituted an abnormal change in circumstances - decision dated 10.10.2013, proceedings no. 1387/11.5TBBCL.G1.S1:

  "*The termination or modification of the contract due to a change in circumstances depends on the confirmation of the following requirements:* ***(i)*** *there is relevant change in the circumstances on which the parties based their decision to enter into a contract,* ***(ii)*** *that those circumstances have changed in an unusual way, and* ***(iii)*** *requiring compliance with the obligation by the injured party would seriously affect the principle of good faith in contracts, and is not covered by the risks of the transaction*"

How the Portuguese courts look at swaps

Abnormal change in circumstances

"*In contracts such as interest rate swaps, in which the parties seek precisely to negotiate an uncertainty, the risk provides the actual object of the contract, and therefore, the change in circumstances must be of considerable weight or extraordinary proportions: the harm only justifies the termination or amendment of the contract when a profound imbalance in the contract is confirmed, it being intolerable for the injured party to support it with good faith.*

Such profound imbalance may result from the significant decrease in interest rates (which fell below 3.95%), caused by the serious financial crisis, with great divergence from the higher rate that the parties represented as possible and that the contract intended to guarantee (in casu 5.15%)".

How the Portuguese courts look at swaps

Abnormal change in circumstances

- Decisions of Portuguese Courts have since changed – including of the Portuguese Supreme Court (although not taken in a swaps case) – and have, more recently, decided that the effects of the financial crisis do not constitute an abnormal change in circumstances for the purposes and effects of article 437 of the Portuguese Civil Code.
- In a decision dated 5.11.2013, the Court of Appeal of Coimbra considered that the sub-prime crisis initiated in 2007 does not constitute an abnormal change of circumstances but a normal and typical crisis of capitalism (proceedings no. 1167/10.5TBACB-E.C1).
- Moreover, in the decision dated 13.5.2014, proceedings no. 309/11.8TVLSB.L1, the Court of Appeal of Lisbon decided that "*the decrease (even if severe) of the interest rates is an inherent risk of the business as it is precisely this factor that leads the parties to enter into this type of contracts. This risk is a normal and inherent hazard of this type of contracts*".

How the Portuguese courts look at swaps

Abnormal change in circumstances

- In a decision of the Portuguese Supreme court dated 23.1.2014, proceedings no. 1117/10.9TVLSB.P1.S1, the court decided that "*On situations of financial crisis, the relevant change in circumstances must be abnormal, which is necessarily connected to unpredictability, as the parties could have foreseen normal changes in circumstances when entering into the contract. Changes to the interest rates and the difficulties in granting banking loans for the payment of the promised price, unemployment and devaluation of currency are concepts that do not fall under the legal provision of abnormal alteration of the circumstances*"

How the Portuguese courts look at swaps

Abnormal change in circumstances

In a recent Portuguese Supreme Court decision, which did not rule on the abnormal change of circumstances, one of the judges argued that (proceedings no. 531.11/7TVLSB.L1.S1):

> *"Article 437, number 1 of the Civil Code excludes from this provision situations in which the abnormal change of circumstances was duly foreseen in the risks of the contracts. In this case we have before us an open ended contract with an aleatory policy and the decrease or increase of the interest rate (depending on the party at stake) is a normal risk that can arise from this type of contracts. Hence, this contract is excluded from the provision of article 437 of the Civil Code (...).*
>
> *Considering the decrease produced over time (for instance in the interest rates applicable to housing loans and the margins applied to these contracts), no financial institution has ever intended to terminate their contractual relations on the basis of abnormal alteration of the circumstances"*

Illegal games of chance

How the Portuguese courts look at swaps

Illegal games of chance

- Article 1245 of the Portuguese Civil Code sets forth that:

  "*Game and wager are not valid contracts and are not source to civil obligations; however, when licit, they are source to natural obligations, except if there is another concurrent motive for nullity or annulment, in the general terms of law, or if there is fraud by the creditor in its execution*".

How the Portuguese courts look at swaps

Illegal games of chance

- The validity of swap agreements has also been challenged on the basis of the same being qualified as illegal games of chance.

- It is argued that, if there is no pre-existent risk when entering into the swap agreements, it is not a means for hedging.

- Thus, the risk is created by the swap agreement, which means that the parties are speculating, the contract being considered a wager.

How the Portuguese courts look at swaps

Illegal games of chance

- The exception of illegal games of chance has also been subject to different solutions by the Portuguese courts.

- For instance, in a decision dated 21.3.2013, the Court of Appeal of Lisbon decided that a swap agreement which does not hedge a risk or cover a specific financial transaction is a wager agreement and, thus, null and void.

How the Portuguese courts look at swaps

Illegal games of chance

The same Court has, however, decided differently, in a decision dated 8.5.2014.

In this case, the Court considered that "*the inapplicability of the so-called "illegal games of chance exception" (article 1245 of the Portuguese Civil Code) to interest rate swap agreement corresponds to the relevant role that this sort of agreements represents nowadays in the financial management of the indebtedness in the business activity*" (proceedings no. 531/11.7TVLSB.L1-8).

How the Portuguese courts look at swaps

Illegal games of chance

Most importantly, the Court also considered that:

"*interest rate swap agreements are admissible in our legal system, even when there is no underlying asset to the notional value, and any speculative purposes can only be deemed relevant if they are, firstly, illegal (and not only speculative) and if, secondly, they are shared by both parties, which is not the case just because a swap agreement was entered into regarding a fictitious or hypothetical notional, without any underlying*" (proceedings no. 531/11.7TVLSB.L1-8).

How the Portuguese courts look at swaps

Illegal games of chance

In another decision from the Court of Appeal of Lisbon, dated 13.5.2014 (which has been confirmed by the Portuguese Supreme Court), it considered that "*a swap agreement is a lawful contract, accepted and protected by our legal system, and that, considering its essential elements, it is not to be confused with the illegal games of chance foreseen in article 1245 of the Civil Code*" (proceedings no. 309/11.8TVLSB.L1).

In this decision it is explained that, "*the speculation that is supposed to exist in the financial markets, and without which it would be impossible to counteract low cycles, for example, does not deserve to be censured by law. In illegal games of chance, there is a speculation which is independent from any justification*" (proceedings no. 309/11.8TVLSB.L1).

Violation of public order

How the Portuguese courts look at swaps

Violation of public order

In a recent decision from the Portuguese Supreme Court, dated 29.1.2015 (procceedings no. 531/11.7TVLSB.L1.S1), the Court considered that the swap agreement in question, violated public order principles and was offensive to good practices and, thus, null and void.

The Court considered that, in this particular case, there was no underlying asset, and thus the swap agreement was a speculative transaction with no "cause" or justification.

Although the Portuguese Supreme Court accepts, in general, the existence of speculation, in this particular case it did not accept speculation "*disconnected from any referential (even if dissimulated under something as vague as "risk management"), [as] it is not susceptible to correspond to a relevant interest from an economic point of view and worthy of legal protection*".

How the Portuguese courts look at swaps

Violation of public order

It should be noted that this decision assumes that this particular swap agreement is null, but not that all swap agreements are null, stating that: "*It should be also noted that we have only taken into consideration this particular swap agreement and we have not analysed every single swap agreement that bind Portuguese companies...*" *(...) it is clear for us that this decision may not, without further ado, be transmuted in a censorial decision to all interest rate swap agreements*".

How the Portuguese courts look at swaps

Violation of public order

More recently, the Portuguese Supreme Court has issued a new decision in which it considers that swap agreements, even when speculative, are not invalid (decision dated 11.2.2015, proceedings no. 309/11.8TVLSB.L1.S1):

"*A derivative can be used without any connection to an underlying nominated agreement, since the swap agreement is in itself sufficient, and is not considered purely speculative solely due to the inexistence of an underlying, as it may have a hedging purpose.*

It will only be considered speculative when speculation is its only purpose".

How the Portuguese courts look at swaps

Violation of public order

"*Nonetheless, speculation is a legitimate purpose that, in itself, is not to be confused with the typical purpose of the illegal games of chance exceptions.*

Thus, interest rate swap agreements which do not have direct hedging purposes, having, e.g., a financial risk managing purpose, are not prohibited by law, but are rather accepted and regulated.

Interest rate swap agreements with a notional value that does not correspond to an actual liability are also not prohibited".

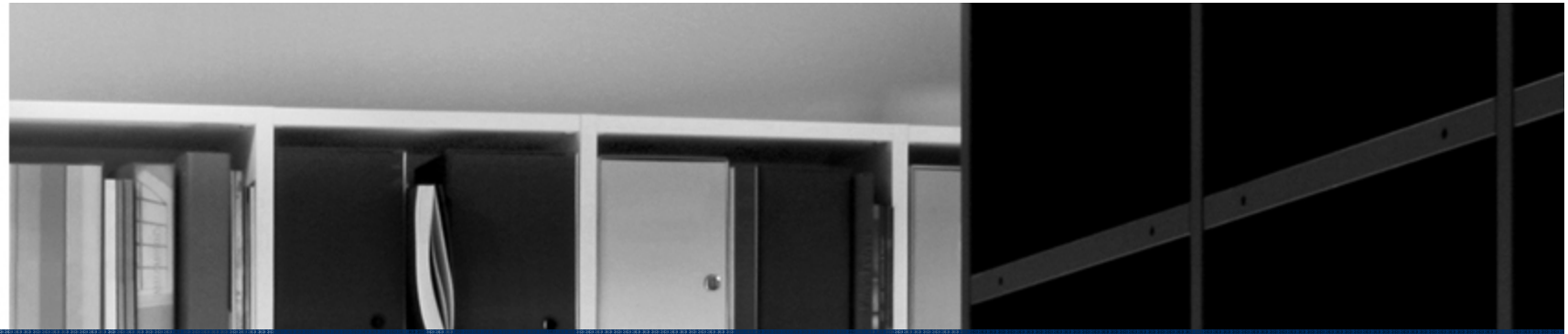
Future prospects

Future prospects

- Court decisions regarding swap agreements are highly publicised in Portugal, which contributes to the rise in the number of the proceedings filed.

- It is possible the decision of the Portuguese Supreme Court dated 29.1.2015 – different to any other - leads more companies to challenge their swap agreements.

- However, in view of the most recent decision of the Portuguese Supreme Court dated 11.2.2015, we expect future Court decisions to become unanimous in recognizing the validity of swap agreements in light of EU and Portuguese law.



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