A fair exchange

Chris Webber and Michael Davar weigh up the impact of the Rome Convention in financial derivatives claims

Chris Webber (pictured top) is a partner and Michael Davar an associate with Squire Patton Boggs LLP

'The English Court of Appeal has restored the vital certainty engendered by derivatives having a clear, single choice of law and not potentially being subject to "mandatory" rules of other jurisdictions that have not been anticipated and addressed by the draftsman.'

In the sphere of financial derivatives, claims in the English courts by foreign municipalities and other public bodies subject to special legislation have, since 2008, been numerous. In particular, there have been a number of disputes over whether foreign 'mandatory' laws apply to derivative contracts by operation of Art 3(3) of the Rome Convention despite the parties' express choice of English law.

The recent Court of Appeal judgment in *Dexia Crediop SPA v Comune Di Prato* [2017] has provided some much-needed clarification and certainty as to the operation of Art 3(3) of the Rome Convention in interest rate swaps and other derivatives with an international element. The case also provides useful guidance as to how foreign law issues are to be dealt with in the English courts and whether the mark-to-market (MTM) of a swap can be considered an initial cost.

Background facts

By December 2001, the finances of the Comune Di Prato (Prato), an Italian local authority, had come under pressure. Prato's borrowing amounted to approximately €111m, 88% of which was at a fixed interest rate.

To help manage its liabilities, Prato appointed Dexia Crediop SPA (Dexia) as a financial adviser. Dexia recommended the use of derivatives to hedge against interest rate risk. On 23 November 2002, Dexia and Prato signed an ISDA Master Agreement, which included an English law and jurisdiction clause. The terms of the ISDA Master Agreement were incorporated in six subsequent swap contracts between them, with Dexia entering into six corresponding back-to-back transactions. The last of these, 'Swap 6', was entered into on 29 June 2006, cancelling the pre-existing swaps.

It was this Swap 6 that instigated the litigation as, from 31 December 2010, Prato stopped making payments due under it. Dexia claimed for sums due.

In its defence, Prato contended that it had not had capacity to enter into the swaps as Italian law restricted municipalities from entering into 'speculative' transactions. Prato also alleged that the sale of the swaps had contravened Italian financial services regulations, said to be mandatory rules of Italian law pursuant to Art 3(3) of the Rome Convention.

First instance judgment

The Commercial Court held that the swaps were not *ultra vires* Prato's capacity under Italian local government legislation. The Commercial Court did, however, find that Prato was entitled to rely on rules of Italian financial services regulation that were treated as mandatory pursuant to Art 3(3) of the Rome Convention. As Dexia failed to comply with those mandatory regulations, the swaps were void at Prato's election.

It followed that both parties had restitutionary claims against each other flowing from the voiding of the swaps. The net result was that Dexia owed Prato €327,680.95.

The appeal – its significance in the financial derivatives market and its importance for practitioners

The Court of Appeal handed down a judgment on 15 June 2017 overturning a number of the Commercial Court's findings and ordering Prato to pay Dexia over €12m. In doing so, the Court of Appeal dealt with a number of areas of law important to the financial derivatives market, including:

- the operation of Art 3(3) of the Rome Convention;
- the manner in which foreign law issues are to be dealt with on appeal; and
- whether the MTM of a swap is to be considered an 'initial cost'.

These are addressed below.

Article 3 of the Rome Convention

The Contracts (Applicable Law) Act 1990 (the 1990 Act) incorporated the Rome Convention (and its successor from 17 December 2009, the Rome I Regulation) into the law of the UK.

Article 3(1) of the Rome Convention entitles parties to choose the law which governs their contract. Article 3(3) of the Rome Convention provides an exception in that, where 'all other elements' relevant to the situation at the time when the parties chose the governing law 'are connected with one country only', mandatory rules of the law of that country will apply to the contract regardless of the parties' choice of governing law. In other words, parties to a purely domestic contract cannot avoid important local laws by choosing a foreign governing law.

The swaps in this case were subject to an English governing law clause. Prato therefore sought to rely on Art 3(3) to apply Italian financial services regulations that it said Dexia had breached. The critical question was whether 'all other elements relevant to the situation… are connected with one country only'.

In the first instance judgment, it was identified that Italy was:

- where both parties were incorporated;
- where both parties communicated with each other;
- where the swap contracts were entered into; and
- the place of performance of the obligations.

The Commercial Court therefore held that all the other elements of the swaps at the time of the choice of English law were connected with one country only, namely Italy.

The Court of Appeal, in overturning this decision, emphasised that, in line with *Banco Santander Totta SA v Companhia Carris De Ferro De Lisboa SA* [2017], the Commercial Court was wrong to view the phrase 'elements in the situation' as requiring elements connected to a particular country other than Italy, and as such was wrong to hold that Art 3(3) of the Rome Convention was engaged. The relevant question was whether the swaps were international or domestic in nature, not whether they were connected to one country more than another.

The critical question in Dexia *was whether 'all other elements relevant to the situation… are connected with one country only'.*

The Court of Appeal re-affirmed, and added to, the relevant factors stated in *Banco Santander*, namely:

- whether there is a right to assign the contract to a party outside the country where the original contracting parties are based;
- whether standard international documentation had been used in the transaction;
- the practical necessity for a relationship with an institution outside the country where the original contracting parties are based;
- the international nature of the financial derivatives market in which the contracts were concluded;
- whether back-to-back contracts are routinely concluded with institutions outside the country where the original contracting parties are based; and
- whether international organisations participated in a tendering process before the derivative contract was agreed.

The Court of Appeal went even further. By incorporating the ISDA Master Agreement into the swaps, the Court of Appeal found that the swaps, by their very nature, had an international element. It was therefore impossible to say that 'all other elements' except the choice of law and jurisdiction clause were located in Italy. This is as:

- the ISDA Master Agreement is the standard form of master agreement of the International Swap Dealers Association Inc and is therefore not associated with any particular country;
- the form is the Multi-Currency Cross-Border form – as there is the option to use a 'Local Currency – single jurisdiction form', the court said this means that the parties must have contemplated more than one currency and the involvement of more than one country; and
- the form is signed by the parties in English, despite both parties' first language being Italian.

As the court held that Art 3(3) of the Rome Convention was not therefore applicable, the rules of Italian law relied on by *Prato* had no application to the swaps.

This is a significant decision for the financial derivatives markets. The English Court of Appeal has restored the vital certainty engendered by derivatives having a clear, single choice of law and not potentially being subject to 'mandatory' rules of other jurisdictions that have not been anticipated and addressed by the draftsman.

Practitioners can now advise with confidence that Art 3(3) of the Rome Convention will rarely, if ever, come into play in relation to derivative contracts based on the common ISDA Multi-Currency Cross-Border document suite.

Foreign experts on appeal

Financial derivative cases often involve foreign law expert evidence. Examples

include cases where a party alleges a lack of capacity to enter a derivative contract based on foreign and legal regulatory requirements, as well as disputes arising under Art 3(3) of the Rome Convention, both of which arose in this litigation.

English law treats foreign law issues as questions of fact to be proved by evidence of suitably qualified experts. The task for the trial judge is to determine what the *highest relevant court* in the foreign legal system would decide if the point had come before it.

Except in the matters identified by CPR 52.21, such as where it is in the interests of justice to hold a rehearing, an appeal is limited to a review of the decision of the trial judge. When the Court of Appeal is faced with a finding by a trial judge on disputed issues of foreign law, the appeal would be one against findings of fact – something with which appellate courts have been repeatedly warned not to take lightly when deciding to interfere.

The Court of Appeal took the firm view in Dexia *that the mark-to-market value is just a calculation of possible future payment flows, and therefore not really a 'cost' at all.*

The Court of Appeal in *Dexia* reiterated the key considerations in reviewing findings of foreign law, stating that appellate courts will show a general reluctance to intervene in cases involving findings of foreign law. Exceptions might arise where it appears that:

- similar rules of construction to the English rules govern the interpretation of the foreign statute;
- none of the words of the statute have any special meaning different from their ordinary meaning in the foreign context; or
- the English judge's common law experience and training can be applied.

This general reluctance arises because the trial judge has the advantage of taking in the whole 'sea' of the expert evidence rather than just 'island hopping', as the appellate court must necessarily do.

In taking this approach, the Court of Appeal held that it was in no position to recreate the trial judge's experience from a reading of the transcript and rejected Prato's appeals of its Italian-law-based capacity defences.

Dexia is a useful reminder of, and potential expansion on, the limits on appellate courts' interference with first instance decisions on foreign law issues. Practitioners will need to think twice when advising whether to appeal findings on foreign law expert evidence. The Court of Appeal warned that it should not be assumed all such points are fully reviewable on appeal, reiterating that the first instance trial is 'not a dress rehearsal. It is the first and last night of the show'.

MTM of a swap

Prato argued that the MTM of Swap 6 was an implicit cost of the derivative, and that Swap 6 breached the so-called 'financial advantage' test under Italian financial regulation, rendering the swap void.

The Court of Appeal dismissed Prato's case in this area for other reasons, but nonetheless considered whether the MTM of a swap was an 'initial cost'.

A swap necessarily involves two-way flows of payment obligations. The MTM of a swap involves estimating and valuing those future payment flows as at the present date. Hence the MTM will be zero where the present estimated value of what has to be paid on the fixed leg is the same as what it is estimated will have to be paid on the floating leg. Where the estimated present values of the legs diverge, the MTM will no longer

be zero. A swap's MTM will therefore vary throughout the life of a swap, depending on estimates of the present value of the different legs at any given time.

The Court of Appeal agreed with the Commercial Court on the following:

- The initial MTM does not indicate an outcome: it is the present value of the expected cash flows discounted at present market rates. The outcome depends on what happens to the market rates.
- Far from being a predictor of cash flows, MTM represents an adjustment to a notional benchmark, representing the provision that the bank has made for costs, risks and return.
- The MTM is based on the spread between the fixed rate and a notional interbank rate, at which no bank would transact with a counterparty like Prato.
- Given the mechanics, it is only in hindsight that it is possible to establish whether such transactions represent an advantage or a disadvantage.
- In these respects, therefore, the initial MTM does not represent a cost, or even an expected cost. It is really just an estimate of future costs, which may or may not transpire.
- The Court of Appeal was accordingly not willing to treat the MTM as a financial advantage gained by Dexia at its customer's expense.

This approach is significant. Local laws often prohibit public bodies from entering into transactions that increase their borrowing or are considered financially detrimental. The notion that the initial MTM is not a 'cost' at all will give increased certainty to financial institutions when structuring financial derivative products for such clients.

Concluding comments

The Court of Appeal judgment helpfully tackles the argument, made in numerous cases in recent years, that the day-one MTM value of a swap represents a hidden 'cost' or financial disadvantage to the buyer. The Court of Appeal's firm view that the MTM value is just a calculation of possible future payment flows, and not really a 'cost' at all, will undermine arguments that the MTM 'cost' represents a secret profit or charge alleged to have been wrongfully concealed from the buyer, as is often argued in mis-selling claims.

Dexia also resolves controversy that arose as a result of the conflict between the first instance decision and the *Banco Santander* judgment. If it can now be said that all swaps based on this widely used ISDA Master Agreement are not affected by Art 3(3) of the Rome Convention, then banks can have confidence that the choice of English law often embedded in ISDA-based swaps will govern all aspects of the transaction, at least where the dispute is before the English courts.

Contracting parties may want to consider taking advantage of this certainty by using this ISDA document suite rather than other forms of derivative contract. In order to exclude Art 3(3) of the Rome Convention, contracting parties may also want to ensure the existence of international factors, such as choosing international counterparties for back-to-back swaps or contracting through a group entity in a different jurisdiction to the swap buyer, in order to exclude Art 3(3) of the Rome Convention wherever possible.

Grey areas do remain. Whether financial derivative products using different standard forms to the ISDA Master Agreement will exclude the operation of Art 3(3) of the Rome Convention in the same way is uncertain. Also, the Rome Convention and Rome I Regulation differ subtly in wording. Although we believe a similar approach will likely be taken with Art 3(3) of the Rome I Regulation, it is not guaranteed. In the longer term, the answer to the question of how Brexit will impact on the incorporation into English law of the Rome I Regulation, which is an EU legislative instrument, is unclear.

Overall, the Court of Appeal judgment reflects the English courts' wider emphasis on clarity and certainty in the context of the international financial derivatives markets, where participants need the interpretation of widely used standard form agreements to be consistent and predictable. It is in part for that reason that the English courts have generally been resistant to attempts by parties to undermine their derivative contracts by later raising arguments such as lack of capacity, non-disclosure of MTM hidden costs or breach of rules of a foreign law not chosen to govern the agreement. Decisions like *Haugesund Kommune v Depfa ACS Bank* [2010] and *Credit Suisse International v Stichting Vestia Groep* [2014] can also be considered as part of that pattern.

Whether financial derivative products using different standard forms to the ISDA Master Agreement will exclude the operation of Art 3(3) of the Rome Convention is uncertain.

The English court system has set out to continue to attract international financial services disputes in an increasingly competitive global marketplace for dispute resolution. Innovations like the Financial List of the Chancery Division and Commercial Courts, specialist training in finance matters for List judges and the (as yet largely untested) test case mechanism for financial markets issues are part of that push. The courts are also alive to the need for the substantive rules of English law to be attractive to the financial markets in promoting certainty, and this decision will be welcomed in that respect. ■

Banco Santander Totta SA v Companhia Carris De Ferro De Lisboa SA & ors [2017] EWCA Civ 1267

Credit Suisse International v Stichting Vestia Groep [2014] EWHC 3103 (Comm)

Dexia Crediop SPA v Comune Di Prato [2017] EWCA Civ 428

Haugesund Kommune & anor v Depfa ACS Bank & anor [2010] EWCA Civ 579