INTEREST RATE SWAP CONTRACTS AND THE GOVERNING LAW CLAUSE OF THE ISDA MASTER AGREEMENT

A critical analysis on the obstacles faced in light of the Rome I Regulation and of the Brussels I Regulation

Master in Transnational Law

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Keywords

I. **Interest rate swap contract** – a contract according to which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically.

II. **Single country agreement** – agreements that are entered into within the same jurisdiction.

III. **ISDA Master Agreement** – a standard document published by the International Swaps and Derivatives Association (ISDA) that governs over-the-counter derivatives transactions.

I. Introduction

"*Derivatives are used by more than 94% of the world's largest companies*"[1], which means that "*with €471 trillion in notional amount outstanding as of December 2008, the global derivatives market was more than five times larger than the global equity and bond markets combined*".[2]

Interest rate swap contracts are a financial derivatives instrument that can be defined as a "*transaction in which one party pays periodic amounts of a given currency based on a specified fixed rate and the other party pays periodic amounts of the same currency based on a specified floating rate that is reset periodically*".[3] In other words, a swap is an agreement between two parties to exchange sequences of cash flows for a period of time.

The proliferation of interest rate swap contracts together with its complexity gave rise to several disputes before courts all over Europe. One of those disputes involved several known Portuguese public companies and the Portuguese branch of one of the biggest banking groups in the world, Santander. Furthermore, substantial amounts were at stake and the decision would have a considerable impact in the Portuguese GDP. The combination of these factors made the judgment that was taking place before the High Court of Justice, in the United Kingdom, a "hot topic" in Portugal. I got especially curious about this subject when I realized that, apart from the financial nature of the decision, relevant questions of international private law arose.

Therefore, I decided to further explore this topic, using the decision in the Banco Santander Totta *v.* Portuguese public companies' case[4] ("The Banco Santander Totta decision") as a starting point to then reflect on the legal obstacles these agreements may face. I was especially motivated when I understood that the core question raised in this judgment could

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[1] Deutsche Borse Group, *The Global Derivatives Market A Blueprint for Market Safety and Integrity*, p. 10 (available in http://deutsche-boerse.com/blob/2532344/ebd7dc9b7aeac3efdf0c273309093130/data/the-global-derivatives-market-0909_en.pdf).

[2] *Ibidem, p.4.*

[3] R. Venkata Subramani, *Accounting for Investments*, *Fixed Income Securities and Interest Rate Derivatives – A Practitioner's guide*, Vol. II, (Willey, 2011), p. 283.

[4] Banco Santander Totta S.A. and Companhia de Carris de Ferro de Lisboa S.A., Sociedade de Transportes Colectivos do Porto S.A, Metropolitano de Lisboa E.P.E. e Metro do Porto S.A. [2016] EWHC 465 (Comm).

come up in any case concerning single country interest rate swap contracts entered into under the ISDA Master Agreement[5], which increases the relevance of this research topic. Moreover, when investigating the subject, I came across another challenge of international private law that sparked my interest, the possibility of recognition and enforcement of these decisions in Portugal.

Hence, I will start by explaining what is the ISDA Master Agreement, the model under which the majority of the derivatives contracts are concluded. Among other characteristics that will be clarified further ahead, the ISDA Master Agreements allows the parties to choose both the competent court and the governing law. This option opens the door to the possibility of the parties choosing the most favorable law to their interests, also known as "forum shopping". This practice and its relationship with the law of conflicts will be explored in chapter III.

Once understood how the derivatives market works, we can then address the questions of international private law that arise. Firstly, we will explore one of the exceptions to party autonomy regulated by article 3 (3) of the Rome I Regulation. Single country interest rate swap contracts are entered into between parties of the same country and yet the governing law is a foreign law, usually English law. In light of article 3 (3) of the Rome I Convention, when *all other elements relevant to the situation at the time of the choice are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement*. Thus, the question comes up: are the elements of a single country interest rate swap contract located in one country or are there enough elements to internationalize the agreement in order to avoid the application of article 3 (3)?

Having provided an answer to this first question, we will then move to another moment in the timeline of a decision – its recognition and enforcement. Article 45 of the Brussels Regulation and its public policy exception may also constitute an obstacle to swap contracts in light of Portuguese law. We will briefly go through the relevant case-law and the literature's position in order to understand, firstly, whether the Portuguese law is being violated and secondly, whether those provisions integrate public policy so as to trigger the public policy exception of article 45 of the Brussels Regulation.

[5] This model of agreement will be explained in chapter II.

II. The ISDA Master Agreement

Derivatives can be traded in the over-the-counter (OTC) markets, meaning directly between two parties outside a regulated exchange or trading venue. The need to harmonize the terms and the conditions of the agreements entered into in such an informal and diversified market as it is the OTC led the International Swap and Derivatives Association to publish, in 1987, the ISDA Master Agreement.

This instrument sets forth a framework agreement that governs all the terms of the trading relationship of a derivatives transaction, a common language all the participants of the OTC market speak. It is a bilateral agreement composed of the master agreement, the main document that is never altered except to introduce the name of the parties. The Master is divided in 14 clauses that are called sections. The core provisions of the agreement, in the 2002 version, are the Event of Default and Termination Events (section 5), the Early Termination Section (section 6) and the Definitions' section (Section 14). During the formation of a contract, these are the terms and conditions that require more negotiation and can be the cause of a deadlock or even a rupture. With ISDA, these negotiations become a lot simpler, as there is common ground and a standard starting point under which the parties can then negotiate.

As was anticipated in the introduction of this thesis, one of the topics that will be addressed is the single country interest rate swap contracts entered into via the ISDA Master Agreement, namely the obstacles that may come up with the choice of governing law. Thus, it is important to have a visual representation of the clause that gives rise to the issues at hand. Let us examine Clause 13 of the ISDA Master Agreement:

"13. 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 any dispute arising out of or in connection with this Agreement ("Proceedings"), each party irrevocably:*

i. submits:

1. if this Agreement is expressed to be governed by English law, to (A) the non-exclusive jurisdiction of the English courts if the Proceedings do not involve a Convention Court and (B) the exclusive jurisdiction of the English courts if the Proceedings do involve a Convention Court; or

2. if this Agreement is expressed to be governed by the laws of the State of New York, to the non-exclusive jurisdiction of the courts of the State of New York and the United States District Court located in the Borough of Manhattan in New York City;

ii. waives any objection which it may have at any time to the laying of venue of any Proceedings brought in any such court, waives any claim that such Proceedings have been brought in an inconvenient forum and further waives the right to object, with respect to such Proceedings, that such court does not have any jurisdiction over such party; and

iii. agrees, to the extent permitted by applicable law, that the bringing of Proceedings in any one or more jurisdictions will not preclude the bringing of Proceedings in any other jurisdiction.

[…]".

By reading section 13, we came to the conclusion that the ISDA Master Agreement promotes the choice of either the English law[6] or the law of the State of New York as the governing law of the agreement. This conclusion is strengthened by the User's Guide to the ISDA 2002 Master Agreement[7] that states that "*Parties that wish to elect a governing law for the 2002 Agreement other than the English law or the laws of the State of New York should carefully*

[6] Out of curiosity, due to Brexit, the International Swap and Derivatives Association is drafting an ISDA Master Agreement with governing law and jurisdiction clauses pointing to France or Ireland.
[7] Available in: http://amwellclear.co.uk/w/images/6/67/ISDA_2002_User_Guide.pdf.

consider such an election with their legal advisers."[8] It is ISDA's recommendation that the parties choose the courts of the country whose law they defined as the governing law of the agreement[9]. Thus, the governing law and the jurisdiction clause should point in the same direction.

This suggests that the International Swap and Derivatives Association promotes what is called "forum shopping", a practice that can be defined as the choice of the most favourable law to the parties. In the derivatives' world, it is clear that both the English law and the law of New York are those favoured by the parties to derivatives contracts, mostly because of the use of the ISDA Master Agreement in the majority of OTC transactions. We will address this practice in the next chapter and provide some justifications for the choice of law and jurisdictions made by the ISDA Master Agreement.

Apart from the Master Agreement, there is also the schedule to the agreement that allows the parties to modify the standard terms of the master agreement, in order to customize it. It addresses topics such as Termination Provisions, Tax Representations, Agreement to Deliver Documents, Miscellaneous and Other Provisions. Through this annex the parties can either choose between various options present in the Master Agreement or add new provisions. For instance, it is in the Annex that the parties can choose whether the contract will be governed by the English law or by the law of New York. Lastly, a Credit Support Annex can also be incorporated where details of collateral arrangements are provided[10].

The adoption of the ISDA Master Agreement in the majority of the transaction in the OTC markets brought about several benefits. Firstly, there is a standardised instrument that allows the parties to "speak the same language" while negotiating (the extensive role of definitions provided in the master agreement is a useful tool), keeping, however, the margin to customize the agreement to their needs through the annex. Secondly, it promotes cost effectiveness and efficiency. Even though the terms and conditions have to be negotiated, the basic terms are harmonized, which shortcuts the process. Thirdly, several risks of the OTC market are

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[8] User's Guide to the ISDA 2002 Master Agreement, p. 38.

[9] 2018 ISDA Choice of Court and Governing Law Guide, p. 10 (available in https://www.isda.org/a/7YsEE/180130_ISDA-Choice-of-court-and-governing-law-guide-prepublication-fina.._02262018.pdf) - "*Parties should note that the model clauses have been drafted with English law and the laws of the State of New York in mind together with the use of the corresponding 'local' courts in each case*".

[10] To know more about the ISDA Master Agreements: Paul. C. Harding *Mastering the ISDA Master Agreements (1992 and 2002)* (Financial Times-Prentice Hall, 2004).

mitigated by the use of the ISDA Master Agreement. When it comes to dispute resolution, the agreement provides certainty regarding the means available. Furthermore, it increases transparency in a market where real and updated information about the counterparty may be difficult to obtain. Lastly, it reduces counterparty risk (the risk of default) and increases liquidity.

As a final clarification, while the 1992 ISDA Master Agreement offered two forms of Master Agreement - a Local-Currency/Single Jurisdiction where the parties are located in the same jurisdiction and use the same currency or a Multi-Currency/Cross-Border -, the 2002 Master Agreement intends to be exclusively a Multi-Currency agreement.[11]

III. Forum Shopping – what is it and why does it occur in swap contracts?

Forum Shopping is a practice that can be described as "*the attitude of a person involved in an international dispute who takes his case to the court of a particular country not because it is best placed to hear the dispute but only because, under its rules on conflict of laws, it would apply the law giving the most advantageous result for this person*."[12]

The jurisdiction and the governing clauses of the ISDA Master Agreement are an example of this practice. The agreement allows the choice between the English law or the law of New York, which sets the conflict of laws system aside and illustrates a clear preference for these two jurisdictions.

Before we get into the details of why the ISDA Master Agreement is designed this way, some remarks have to be made regarding the relation between *forum shopping* and the rules on conflict of laws. These considerations will only concern the European Union reality so let us disregard for a moment the possibility to choose the law of New York.

The parties' interest in an agreement to choose the law and jurisdiction that will govern their contract only exists due to the largely disparate legal systems of the Member-States. What seems to be an obvious statement is indeed for some authors the proof that the conflict of laws systems have failed to achieve their main goal – uniformity of result regardless of the location

[11] User's Guide to the ISDA 2002 Master Agreement, p.1.

[12] *GREEN PAPER on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation*, presented by the Commission, p.44 (available in https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:52002DC0654&from=EN.)

of the suit.[13] Hence, there is only space for forum shopping due to the lack of harmonization of private law among Member States. Nevertheless, one could ask if the unification of private law is desirable. Whilst we will not delve deep into this subject on this occasion, it is arguable that one of the means to achieve the political integration in Europe would be through the unification of private law, reducing to a minimum the autonomy of the domestic legal systems and leaving no space for forum shopping. However, it is my belief that the *"the advantages of legal pluralism outweigh the disadvantages."*[14] The competition between the Member States to offer the best legal solution will create a sort of legal lab where several solutions will be tried out, enhancing the search for the best way to deal with a certain legal problem. Secondly, the legal system of a country is built to cope with the specific problems of a social, economic and cultural reality. Unification of private law would make the rules less suited to the domestic challenges. Lastly, one should not forget that different levels of harmonization could be applied to different areas of private law. Thus, "*there are undoubtedly clearly defined areas where unification is essential, such as customs law and certain areas of economic law, the law on aliens [...], company law and consumer contract law*."[15]

With unification being difficult and undesirable to achieve, forum shopping will continue to occur. Indeed, it is an expression of the principle of freedom of choice, the cornerstone of private international law. Parties' self determination should be respected as far as values such as certainty and predictability are at stake.

Nevertheless, the lack of limits to this practice would unquestionably undermine the role of the law of conflicts. Private international law as a legal discipline exists to decide which jurisdiction has competence over an international situation by choosing the most relevant connection with it. If we allow the parties to replace *"the result of centuries of evolution and careful balance of the interests at stake"*[16] that culminated in a solid system of law of conflicts with their own will in every case and situation, the value of justice would be endangered.

Consequently, limits to forum shopping and to party autonomy are required. The principle of freedom of choice only operates in relationships where the parties are given the faculty to choose the governing law (e.g. contractual obligations). And even here, limits are defined and

[13] C. Granger, *The Conflict of Laws and Forum Shopping: some recente decisions on jurisdiction and free enterprise in litigation,* Vol. 6:416 (Ottawa Law Review, 1974), p. 471, available in *https://commonlaw.uottawa.ca/ottawa-law-review/sites/commonlaw.uottawa.ca.ottawa-law-review/files/25_6ottawalrev4161973-1974.pdf*.
[14] Luís de Lima Pinheiro, *Estudos de Direito Internacional Privado* Vol. II (Almedina, 2009), p. 167.
[15] Idem, p.166.
[16] Idem, p. 184.

article 3 (3) of the Rome I Convention, the core provision of the next chapter, is an example of this. Parties cannot use forum shopping to escape the mandatory rules of the legal system they have the best connection with. Otherwise, forum shopping would be the perfect way to practice fraud.

Having provided these clarifications on forum shopping and on their relationship with the law of conflicts, it is time to answer the question of why the ISDA Master Agreement has chosen the English Law or the law of the state of New York.

The answer comes down to the role of the UK and the US in financial markets. London and New York are the world's financial capitals and the English language is the official language of the financial industry and of derivatives markets. Moreover, or as a consequence of it, their judges have more expertise and knowledge on the subject, what in theory allows them to render technical decisions more skillfully and in less time. Additionally, the assignment of the contractual position is a common practice in the derivatives contracts and the need for legitimate expectations as to the court that will settle the disputes is the ground for those assignments. Lastly, there is a clear preference for the common law system, could be justified by the central role of the judge and of precedent.

IV. Is the Rome I Regulation an obstacle to single country interest rate swap contracts?

a. The Rome I Regulation

The Rome I Regulation applies to contractual obligations on civil and commercial matters (article 1 [1]). Thus, since interest-rate swap contracts do not fit into any of the exceptions featuring in article 2 (2), they are covered by the Regulation.

Article 1 also states that the Rome I Regulation applies to situations involving a conflict of laws. The core discussion of this thesis being a situation that could be defined as a purely domestic situation - since all the elements are connected with a single country, despite the parties having chosen a foreign law -, it is inevitable to ask whether there is a real conflict of laws. In other words, is the Rome I Regulation applicable to the situation at hand? Authors do not have a uniform answer to this question, even though there is a clear trend. The large majority supports the idea that the Regulation applies to contracts that do not have an

international nature, being the choice of a foreign law to govern the contract by parties of the same country a sufficient element to place the agreement within the scope of the Regulation[17]. Others state that the purpose of article 3 (3) of the Rome I Regulation is not to address a situation where there is not a real conflict of laws[18]. The assumption followed on this thesis, along with the majority of the authors, is that the choice of a foreign law is sufficient to create a conflict of laws, with the Banco Santander Totta decision being a good example of this.

As it was explained before, the ISDA Master Agreement allows for the choice of the applicable law to the contract. This possibility is in accordance with what is the cornerstone of European Private International Law in matters of contractual obligations: party autonomy, with the Rome I Regulation (article 3 (1)) being the perfect example. The principle of freedom of choice establishes that "*the parties are free to determine the law applicable to their contract by agreement*"[19]. Hence, as long as there is no dispute as to its validity, the choice is absolutely free. No connection with the parties or the contract in necessary to choose the applicable law to the contract[20] or, as common law refers to, the proper law of the contract.

However, exceptions to party autonomy are made throughout the Regulation, namely on articles 5 (2) and on article 7, where party autonomy is limited when choosing the applicable law to the contract: in carriage contracts, the choice is limited to five jurisdictions, the same being applicable to small insured risks.

Moreover, it was the European legislator's intention to limit the aforementioned forum shopping, where the parties to a contract try to circumvent the application of mandatory provisions of the legal system they have the closest connection with by choosing another legal order as the governing law. This is the rationale behind article 3 (3), the key provision of this

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[17] Mario Giuliano and Paul Lagarde, *Report on the Convention on the law applicable to contractual obligations*, p.10 (available in https://eur-lex.europa.eu/legal-content/EN/TXT/PDF/?uri=CELEX:31980Y1031(01)&from=EN);
Franco Ferrari and Stefane Leible, *Rome I Regulation – The Law Applicable to Contractual Obligations in Europe* (Sellier. European Law publishers, 2009), p. 2: "*European conflict of laws even provides the choice for contracts which are, except for a choice in favour of another law, exclusively connected to one and the same country*";
Michael Bogdan, *Concise Introduction to EU Private International Law* (Europa Law Publishing, 2016, 3º ed.), p. 115: "*The Regulation applies in principle even to contracts that do not have international character, i.e., those contracts where all elements are connected with one single country only, regardless of whether this is a foreign country or the country of the forum.*"

[18] Luís de Lima Pinheiro, p. 417.

[19] Franco Ferrari and Stefane Leible, *Rome I Regulation – The Law Applicable to Contractual Obligations in Europe*, p. 2.

[20] Geert Van Calster, *European Private International* Law (Hart publishing, Bloomsbury Publishing Plc, 2016, 2º ed.) p. 203.

chapter that will be explored further ahead. A final remark to article 9 of the Regulation (Overriding mandatory provisions), which constitutes itself a limitation to party autonomy.

Party autonomy is one of the principles the Rome I Regulation upholds, together with a high degree of predictability and "*room for manoeuver for the forum to correct the default choice in favour of the country the contract is most closely connected*"[21].

The topic of this thesis arises precisely from the balance between party autonomy and the need to apply the mandatory provisions of the legal order the contract is closest connected with.

At this stage, it is important to recall article 3 (3) of the Rome I Regulation in order to correctly frame the problem. Thus, "w*here all other elements relevant to the situation at the time of the choice are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement."*

As was mentioned before, the Banco Santander case decided before the English High Court of Justice will be the focus of this chapter's discussion since it brings the much-needed legal certainty to the governing law clauses in single country interest rate swaps, a grey domain by the time this decision was handed over.

b. Previous case law

Even though we will be relying on the Banco Santander decision as the correct framework on how to address the topic of this thesis, it is important to walk through the previous case law to understand how the High Court of Justice reached the interpretation provided in the decision.

Both the England High Court of Justice (first instance) and the Court of Appeal were called to decide on the application of the Rome I Convention (the predecessor of the Rome I Regulation) to single country interest rate swap transactions a few times. During this chapter, I will refer to both the Rome I Convention and the Rome I Regulation, depending on which one was in force at the time the swap contracts were entered into. Nevertheless, despite the

[21] Ibidem.

slight differences in the wording of the provision, "*changes [...] are mostly not intended to bring about a change of content*".[22]

Haugesund Kommune v DEPFA ACS Bank[23], opposed, before the Court of Appeal in 2010, an Irish bank and local municipalities in Norway. In 2014, a case was brought before the High Court of Justice between a bank and a Dutch social housing association[24]. In common, they had interest rate swap contracts entered into between the parties and a choice of law clause determining the English law as the law governing the contractual provisions. Furthermore, one of the questions raised in both cases was similar: did the local municipalities or the social housing association have capacity to enter into these contracts? The Rome I Convention, applicable at the time the contracts were concluded, determines that the issue of capacity is outside its scope of application (article 1/2/f)). Therefore, even though the consequences of the lack of capacity were determined by English law, the legal capacity itself was governed by Norwegian and Dutch law.

However, it was the dispute between *Dexia Crediop SPA and Comune Di Prato*[25] ("Dexia") that raised the question of the applicability of 3(3) of the Rome I Convention to single country interest rate swap contracts concluded under the ISDA Master Agreement whose choice of law clause defined the English law as the governing law. Note that the legal capacity issue was overcome in this decision since under Italian Law, Prato had legal capacity to enter into these contracts.

The case concerned an Italian investment bank and an Italian local authority responsible for the municipality of Prato. The former was appointed to help restructure Prato's debt and, as part of the plan, several interest rate swap contracts were entered into. They followed the ISDA Master agreement and English law was defined as the applicable law to the agreements. When the dispute arose, one of Prato's arguments was that the enforcement of its obligations under the agreements meant the violation of mandatory provisions of Italian law. Therefore, article 3 (3) of the Rome I Convention should be relied upon to determine the application of the mandatory provisions of Italian law that could not be derogated by contract.

Judges were called to decide whether this was a purely domestic agreement or whether there were elements relevant to the situation that were not located in Italy. The parties were both

[22] Franco Ferrari and Stefane Leible, *Rome I Regulation – The Law Applicable to Contractual Obligations in Europe*, p. 1.
[23] Haugesund Kommune & anor v Depfa ACS Bank & anor [2010] EWCA Civ 579.
[24] Credit Suisse International v Stichting Vestia Groep [2014] EWHC 3103 (Comm).
[25] Dexia Crediop SPA v Comune Di Prato [2015] EWCA 1746 (Comm).

incorporated in Italy, the agreement was entered into in Italy and the obligations were to be performed in Italy. Could it be categorized as a domestic situation or was the use of the ISDA Master Agreement enough to internationalize it and block the application of article 3 (3) of the Rome I Convention? "*As to the master agreement, it is true that it is an international standard form, but it does not follow from this that it is an 'element in the situation' which is connected to a country other than Italy. It is of course designed to promote certainty, but that does not give it a connection to a country other than Italy. Nor does the significance and global nature of ISDA. […] Throughout the relevant period everything relevant to the use of the form happened in Italy.*"[26] In that regard, the judges stated that Prato could rely upon the mandatory provisions of Italian financial law that were being violated by the agreements (e.g. the requirement to inform Prato of its entitlement to a 7day cooling-off period). Hence, the use of the ISDA Master Agreement was not enough to render "international" what was defined as a domestic situation and mandatory provisions of Italian law were able to limit the choice of law clause. English law would still be applicable in all matters not related to the mandatory provisions.

This judgement is an example of how the cornerstone of the Rome I Regulation – party autonomy – had to be balanced with the values of the legal systems parties are operating in. The rationale behind article 3 (3) is precisely preventing parties from escaping the internally mandatory provisions of their country, preserving the proper law principle according to which a situation should be governed by the legal order which has the closest connection with it[27]. Hence, a purely domestic case should be governed by the laws of that country as far as mandatory provisions are concerned, with the choice of law clause being valid in all other matters.

It is important to stress that this decision was based on an interpretation of article 3 (3) of the Rome I Convention according to which "elements relevant to the situation" means elements connecting the situation to a particular country[28]. Thus, in light of it, it would be necessary that the elements relevant to the situation pointed to a specific country other than Italy to place the agreement outside the scope of article 3 (3). We will see over this thesis how this interpretation has evolved and how it was key to reach the point where we stand today.

[26] Idem, paragraph 211.
[27] *GREEN PAPER on the conversion of the Rome Convention of 1980 on the law applicable to contractual obligations into a Community instrument and its modernisation*, presented by the Commission, p.10.
[28] Chris Webber and Michael Davar, *A Fair Exchange*, (The Commercial Litigation Journal, July/August 2017), p. 18-21.

c. The Banco Santander Totta decision

The Banco Santander Totta decision was much expected all over Europe since it would determine the future of single country interest rate swap contracts concluded under the ISDA Master Agreement. Would it be possible for the High Court of Justice to uphold the conclusions reached in Dexia and support that the choice of law clause in interest rate swap contracts entered into under the ISDA Master Agreement by single country parties does not affect the application of mandatory provisions of that country's legal system? What would be considered mandatory provisions in a certain legal order? How would the derivatives market react to this scenario of legal uncertainty that would invariably strike millions of interest rate swap contracts? This is precisely the point of view of Adrian Briggs who, despite sustaining that article 3 (3) should be triggered in a domestic situation, acknowledges the danger of such broad interpretation in commercial litigation due to the uncertainty it can bring[29].

Bearing these questions in mind, the High Court of Justice had the chance to reflect again on whether article 3(3) of the Rome I Convention could be seen as an obstacle to single country swap contracts concluded under the ISDA Master Agreement with a governing law clause.

The claimant was a Portuguese bank, affiliate of the Santander group, a Spanish banking giant. The defendants were all public sector Portuguese transport companies operating in Lisbon and Oporto. The dispute arose due to nine interest swap contracts under the ISDA Master Agreement entered into by the parties between 6 June 2005 and 2 November 2007.

Even though it is not my intention to explore the financial characteristics of this instrument, it is important to stress that the interest-rate swaps in question were what is called exotic swaps with a snowball effect, as opposed to vanilla swaps. The latter "*is an interest-rate swap exchanging a fixed leg whose payment depend on a fixed rate for a floating leg whose payment depend on a floating rate in which the notional principle remains constant over the life of the contract and where the maturity of the floating-rate index is identical to the payment frequency of the floating-leg flows*[30]". Nonetheless, what makes the swaps at stake unusual and exotic is "[…] *the incorporation of a "memory" feature. […], once the reference interest rates (EURIBOR and sometimes LIBOR) moved outside upper or lower "barriers",*

[29] Adrien Briggs, *Private Internation Law in English Courts*, (Oxford University Press, 2014), *7.117.*

[30] Lionel Martellini, Philippe Priaulet and Stépanhe Priaultet, *Fixed-Income Securities, Valutation, Risk Management and Portfolio Strategies* (Willey, 2003), p. 324.

the fixed rate payable by the Transport Companies [being the bank the floating rate payer and the public companies the fixed rate payer] *had a "spread" added to it. The spread was cumulative at each payment date, and was subject to leverage [...], hence the swaps being described as "snowball" swaps*[31]".

Furthermore, the long-term nature of these instruments also contributed for its classification as risky derivatives. As a matter of fact, it was the first time the court was called up to decide on a case concerning swap contracts with these features that end up maximizing the consequences of interest rates being close to zero. This was precisely what happened after the financial crisis of 2009, causing massive losses for public companies. Hence, in 2013 they stopped making payments to Santander, with the total unpaid amount in 1 October 2015 adding up to EUR 272,561,157.

While Santander Totta claimed that public companies' obligations under these agreements were valid and therefore enforceable, the defendants argued that these agreements violated mandatory rules of Portuguese law, such as the abnormality in the change of circumstances or the prohibition of "games of chance". That would justify the inapplication of the choice of English law grounded on article 3 (3) of the Rome I Regulation (because all the elements relevant to the situation were connected with Portugal) in what concerns the Portuguese mandatory provisions.

The public companies grounded their defence, in light of Dexia's line of reasoning, on the assumption that there is no element in the agreements that links them to the legal order of any other country apart from Portugal. Thus, mandatory provisions of Portuguese law that cannot be derogated by contract should apply.

Conversely, Santander Totta followed the interpretation of article 3 (3) according to which it is sufficient to identify international elements in the agreements that point away from Portugal to place the agreements outside the scope of the article.

The High Court of Justice adopted Banco Santander Totta's line of reasoning, structuring the entire decision based on the discussion of the international character of the agreements. It stated that "*For the purpose of Article 3 (3) of the Rome Convention, in determining whether all the other elements relevant to the situation are connected with one country only, the*

[31] The Banco Santander Totta decision, paragraph 6.

enquiry is not limited to elements that are local to another country, but includes elements that point directly from a purely domestic to an international situation". [32]

Firstly, the court reflected on the fact that, according to the agreements, Santander Totta could assign its position in the contracts to any subsidiary of Banco Santander Central Hispano S.A. Therefore, the possibility of a non-Portuguese party replacing Santander Totta in the agreements was contemplated since their signatures, which illustrates that the scenario of an international contract was not set aside by public companies.

The claimant used this element relevant to the situation to differ from Dexia's precedent since in the latter there was no provision contemplating the substitution of any of the parties for a non-Italian entity. The defendants sustained that even though this possibility was contemplated in the agreements, at the time of the conclusion of the contracts no assignment of the contractual position had taken place. Hence, the parties to the contracts remained Portuguese during the period they were in place.

The court had to categorize the right to assign the contractual position either as a potential element relevant to the situation or as an actual element relevant to the situation. The question that had to be made was whether Santander Totta would have entered into the agreements if this right was not contemplated. Even though the decision does not elaborate on it, it was the court's conclusion that this was a relevant provision in the agreements. Firstly, due to the dimension of the Santander Group, with several subsidiaries all over the world, which could justify, in order to achieve group's goals, the assignment of the contractual position. Secondly, due to the nature of the contract that creates potential obligations to the bank over the long term. Hence, "*the significance of the bank's right of assignment in the present contract is that the parties envisaged that performance over the substantial period (averaging 14 or so years) that the swaps covered could be by a non-Portuguese bank*"[33]. The perspective offered by the court is incompatible with the public companies' view of the situation as a purely domestic one.

The first conclusion reached by the courts places the situation under analysis outside the scope of article 3 (3) but, most importantly, provides the parties to these contracts with a concrete criterion they can rely on. An assignment provision in an agreement where one of the parties is a cross-border corporate group internationalizes the situation.

[32] The Banco Santander Totta decision, paragraph 404.
[33] The Banco Santander Totta decision, paragraph 409.

Secondly, the court considered the address given by Santander Totta under the interest rate swap contracts, namely the fact that it was a British address. However, the court quickly dismissed this argument, stating that it was irrelevant.

The third element relevant to the situation that was addressed by the court was the use of the "Multicurrency-Cross Border" form (1992 ISDA Master Agreement). In previous transactions, the parties had used a Portuguese framework to enter into swaps agreements. However, by the time the disputed contracts were concluded, they had already switched to ISDA documentation.

At this stage, it is important to recall what the purpose of the Multicurrency-Cross Border form is in order to fully understand the meaning of its use. It is a form designed for international transactions, with the parties involved hailing from different jurisdictions. Despite the fact that the 2002 version of the ISDA Master Agreements is exclusively intended to be used as a multicurrency agreement, the 1992 version, the one used by the parties in these contracts, comprised both a cross-border version and a single jurisdiction form[34]. Therefore, having the chance to choose between the two types of agreements, it was the parties' will to use a multicurrency agreement.

Furthermore, the use of English as the language to define the terms of the agreements must also be taken into consideration. Even though it is the language commonly used in commerce, especially in what concerns banking and finance, the parties are both Portuguese and the agreements must have been negotiated in Portuguese so the question remains – is the use of English a relevant element to the situation?

Both the use of the Multicurrency-Cross Border form and the use of the English language led the court to decide on the question whether the documentation itself should be considered an element relevant to internationalize the situation. It is the court's view that "*there are practical reasons for taking account of the documentation as an element in its own right"*[35].

Indeed, this has been the position adopted by Portuguese Supreme Court of Justice[36] when it was called upon to decide on the validity of the choice of court clause in a swap entered into under the ISDA Master agreement. Even though the question of the competent court addressed by Regulation 1215/2012 (Brussels Regulation) differs from the one we are

[34] *User's Guide to the ISDA 2002 Master Agreement* (International Swaps and Derivatives Association, 2003 Edition).
[35] The Banco Santander Totta decision, paragraph 400.
[36] Ac. STJ 21.4.2016, Process nº 538/14.2TVLSB.L1.S1 (António Silva Gonçalves).

discussing here, the rationale behind both questions is similar: is an international element in the relationship between the parties needed to block the application of article 3(3) of the Rome I Convention, the same way article 25 of the Brussels Regulation[37] requires an international element to avoid the general rule according to which people should be judged in the court of their domicile due to their closest connection with it? Both provisions reflect a deviation from the proper law principle based on freedom of choice. However, they both need an international element that justifies it, otherwise the closest connection (the country where all the relevant elements to the situation are located or the domicile of the defendant) will prevail.

Returning to the Portuguese Supreme Court of Justice's decision regarding the validity of choice of court clauses in a single country swap under the ISDA Master Agreement, it has been its position that the swap contracts have an inherent international nature due to, among other reasons, the use of the ISDA. Hence, the validity of the clause granting jurisdiction to English courts should be assessed in light of article 25 of the Brussels Regulation, being absolutely valid. Thus, Portuguese courts should refuse to accept jurisdiction over this question, with the English courts remaining as the competent ones.

The importance given by the High Court of Justice to the ISDA Documentation in the Banco Santander Totta decision, classifying it as an element relevant to the situation that is not connected with Portugal, is, in my view, the right way to address the question and confirms the harmonized opinion of Portuguese courts in what can be called a "parallel question". A Portuguese court will never be called upon to decide a question concerning the choice of English law in a swap between Portuguese parties since the case will be brought before the competent court (the English Court). Conversely, when it is the jurisdiction of the court that is being disputed, the case will be brought before the Portuguese courts, claiming the invalidity of the choice of court clause. These are "mirror questions" which have the same legal grounding and a different answer to each of them would jeopardize the legal certainty that this topic requires.

Returning to the Banco Santander Totta decision, the fifth element the court had to reflect on was the involvement of both Banco Santander Negócios Portugal S.A. (BSNP), another subsidiary of Santander Spain in Portugal and Santander Spain itself in the agreements.

[37] In light with ECJ's position, namely Owusu (process C- 281/02, paragraphs 25 and 26), Lindner (process C- 327/10 paragraphs 29 and 30) and Maletic (process C-478/12 paragraph 26).

Since these contracts involved a huge risk exposure, Santander Totta adopted what is called the "back-to-back swap" strategy. Hence, to hedge its exposure, Santander Totta entered into reverse swap contracts with BSNP under the ISDA Master Agreement, cancelling the risk of the swaps concluded with the Portuguese companies, as each swap in a back-to-back structure cancels the other one out. The same was done by BSNP by concluding back-to-back swaps with Santander Spain, building a chain with the purposes of hedging risk for Santander Totta, passing it on to Santander Spain via BSNP.

As the string described in the previous paragraph clearly reveals, the involvement of Santander Spain in these transactions is crucial. Firstly, because Santander Totta was dependent on Santander Spain to conclude the swaps, seeing as without the back-to-back swaps, it would not have the structure to bear the risks involved and would not have entered into the agreements with the Portuguese companies in the first place. Secondly, since it would be Santander Spain ultimately bearing the risk of the swaps, it had a central role in defining their terms. Therefore, "*BST did not have the capabilities to sell complex derivatives on its own. It was dependent on Santander to price such derivatives, to calculate the credit risk exposure of the transactions and to hedge BST's market risk through back-to-back swaps*"[38].

Despite the attempt of Portuguese Public Companies to argue that the back-to-back swaps were entered into with a Portuguese bank (BSNP) and that they were not aware of the chain that came after, the High Court of Justice considered the involvement of Santander Spain a relevant element that points way from Portugal.

Another element that was taken into consideration in the court's decision was the fact that swaps were entered into in an over-the-counter (OTC) market. OTC markets are decentralized markets, without a physical location where participants use several communication methods to trade with their counterparty, from telephone to instant messaging. Hence, "[…] *BST swaps were anchored in a market that is necessarily international in its operations*"[39], with this being a relevant element to the situation that is not connected with Portugal. Proof of this argument is the number of swaps the defendants entered into with banks all over the world (USA, Switzerland, UK, Germany, France, Spain and Japan).

[38] The Banco Santander Totta decision paragraph 409, (5), (ii).
[39] Idem 409, (6), (ii).

Lastly, the High Court of Justice addressed the use of international benchmark rates, namely EURIBOR and LIBOR, in the contracts. Nevertheless, it considered this element irrelevant to the situation as even domestic transactions rely on these rates.

In summary, the court was called up to decide which interpretation of article 3 (3) of the Rome I Convention should be adopted in single country agreements. On the one hand, following Dexia, if there is no relevant element that connects the contract with a specific country apart from the one they were entered into in, article 3 (3) must be triggered and mandatory provisions of that legal order must be applied. On the other hand, there is Banco Santander Totta's line of reasoning according to which it is enough to avoid article 3 (3) to have elements that internationalize the agreement, even though they do not connect it with a specific country. In short, the relevant question was whether they were purely domestic contracts or not.

As was already anticipated in this thesis, the court's decision was that *"[...] Art. 3 (3) of the Rome Convention was not engaged because all elements relevant to the situation at the time of the choice were not connected with Portugal only*."[40]

This decision overturned the previous case law of the High Court of Justice and gave a clear interpretation of how article 3 (3) of the Rome I Regulation should be applied when single country interest rate swap contracts are at stake.

The legal certainty regarding the governing law of the agreement, much needed in the derivatives market, was finally brought about by this judgement, closing a door of doubts that was affecting the market. Broadening the interpretation of article 3 (3) the way the court did in Dexia in order to fit a larger number of situations was a much too simplistic approach to the problem and to the derivatives market in the 21st century.

It is important to recall the text of the article so we can fully understand the interpretation given by the court. Therefore, "*where all other elements relevant to the situation at the time of the choice are located in a country other than the country whose law has been chosen, the choice of the parties shall not prejudice the application of provisions of the law of that other country which cannot be derogated from by agreement*". The court's understanding in Dexia was that, apart from the choice of law clause of the ISDA Master Agreement, there was no

[40] The Banco Santander Totta decision, paragraph 411.

other element that connected the contracts with another legal order aside from Italy. Conversely, in the Banco Santander Totta decision, the court stated that in order to escape the scope of application of article 3 (3), the elements did not have to connect the agreements with another country apart from Portugal but merely to internationalize it.

This interpretation is in accordance with the derivatives market itself. When an interest rate swap contract is entered into, it is impossible to anticipate the jurisdictions it will be connected with since it is constantly being traded in markets with participants all over the world. Thus, requiring a connection with a specific country is too demanding for such a volatile product. Moreover, this decision clearly stresses that the purpose of article 3 of the Rome I Regulation is to protect party autonomy and any limitation to it must be as narrow as possible. Indeed, a scenario where the validity of derivatives contracts is constantly being questioned would destroy the market.

d. The confirmation of the right path

The approach followed by the High Court of Justice in Banco Santander Totta decision was confirmed by the Court of Appeal in Dexia[41], overturning the decision of the High Court of Justice in the latter case.

In this judgement, the Court of Appeal assessed several elements, namely the use of the Multi-Currency Cross Boarder form of the ISDA Master Agreement, the fact that the agreements were signed in English and the back-to-back arrangements entered into by Dexia Crediop to hedge its exposure.

It was the court's conclusion that these factors are "*enough on its own to demonstrate an international and relevant element in the situation such that it is impossible to say that all elements (other than the choice of law) relevant to the situation are located in a country other than England such as (in this case) Italy. The international dimension precludes any such assertion.*"[42] Hence, *"once an international element comes into the picture, Article 3(3) with its reference to mandatory rules should have no application*."[43]

[41] Dexia Crediop SPA v Comune Di Prato [2017] EWHC Civ.
[42] Idem, paragraph 134.
[43] Idem, paragraph 137.

These two cases set a precedent regarding the interpretation of article 3 (3) of the Rome I Regulation that is reliable and will remain in place due to its appropriateness to the transnational nature of the derivatives market.

V. The *'Ordre Public'* and the Recognition of the Award (the Brussels I Regulation)

a. The Brussels I Regulation

In the previous chapter, the obstacles a single country interest rate swap contract may face regarding the validity of the choice of law clause were dealt with. Alongside the choice of the governing law of the agreement comes the choice of the competent court. As discussed in chapter III (Forum Shopping), parties that use the ISDA Master Agreement tend to choose not only English law as the governing law but also English courts as the competent ones. Doing otherwise would create situations where a Portuguese court would be applying English law or an English court would be issuing a ruling according to Portuguese law, which is not advisable according to ISDA.

The choice of court (jurisdiction) is regulated by Article 25 of the Regulation nº 1215/2012 (the Brussels I Regulation) and is based, the same way article 3 (3) of the Rome I Convention is, in party autonomy. Even though the grounds on which the validity of the choice of court clause can be challenged will not be addressed in this thesis, since the contracts under analysis do not raise any specific questions, the Brussels I Regulation will be the core of this chapter. In that regard, we will study the last moment of the timeline of a foreign decision, its recognition in the country of origin of the parties.

The Brussels I Regulation provides for rules on jurisdiction and on the recognition and enforcement of judgements in civil and commercial matters. Regarding jurisdiction, it establishes that the court with jurisdictions to settle the dispute is the court of the domicile of the defendant (article 4). There are exceptions to this rule, namely special and exclusive jurisdiction, jurisdiction on matters relating to insurance, consumer contracts and individual contracts of employment. As for the recognition and enforcement of the a decision, it determines a principle of free movement of judgements according to which "*a judgement given in a Member State shall be recognised in other Member States without any special*

procedure being required."[44] There are exceptions and this chapter will focus on one of them – the public policy exception ('*ordre public'*).

In order to fully understand the obstacles a decision regarding interest rate swaps issued by an English court may face when recognized and enforced in Portugal, the wording and the scope of article 45 of the Brussels I Regulation has to be explained.

In what concerns this thesis, article 45 states that:

"On the application of any interested party, the recognition of a judgment shall be refused:

(a) if such recognition is manifestly contrary to public policy ('*ordre publi'*) in the Member State addressed;"

b. The public policy exception

The public policy exception is present in several regulations of European Union law[45] and yet it is rarely applied. This exception was created to protect the ultimate values of the *lex fori* that can be at risk due to the application of a foreign law. However, there is a "*worldwide consensus that the public policy clause operates as an exception – the respective provisions of the European instruments require the old of a manifest contradiction to public policy*"[46]. This can be understood in light of the main idea that is behind the creation of the European Union – to build "*a legal system established to deal with a series of contemporary problems and realise a set of goals that individuals states felt unable to manage alone*"[47].

A public policy exception being often used would jeopardize this purpose since it would isolate each country and each legal order, compromising the goal of mutual recognition among the member states and the free movement of judgements. Thus, even before we look at the case-law addressing the public policy exception, it is clear that the position adopted by the European Court of Justice can only be a narrow interpretation of this concept that defines explicitly the limits of its application. Otherwise, claimants would always rely on the public

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[44] Article 36 (1) of the Brussels I Regulation.

[45] Regulation (EC) No 44/2001, Regulation (EC) No 2201/2003, Regulation (EC) No 1346/2000, Regulation (EC) No 1206/2001, Regulation (EC) No 593/2008, Regulation (EC) No 864/2007.

[46] Directorate General for Internal Policies, Policy Department C: citizens' rights and constitutional affairs legal affairs, *Study on the Interpretation of the Public Policy Exception as referred to in EU Instruments of Private International and Procedural Law*,(available in http://www.europarl.europa.eu/RegData/etudes/STUD/2011/453189/IPOL-JURI_ET(2011)453189_EN.pdf

[47] Damian Chalmers, Gareth Davies and Giorgio Monti, *European Union Law*, (Cambridge University Press, 2014, 2º ed.), p.3.

policy exception as a ground to prevent the recognition and enforcement of a decision issued in other Member States, which would ultimately render the Brussels I Regulation useless.

With this assumption in mind, a closer look at the pertinent case-law will allow us to understand the threshold for triggering the public policy exception in order to apply it to interest rate swap contracts. A previous remark has to be made regarding the legal basis of the majority of the case law since at the time of the decisions, one of the two predecessors of the Brussels I Regulation, namely the 1968 Brussels Convention and the Regulation (EC) No 44/2001, was in force. Since the wording was kept the same over the instruments with only slight changes, the case-law is perfectly applicable and can be relied upon. The 1968 Brussels convention only required a decision to be "contrary to public policy"[48] to prevent its recognition in the Member State where it was sought. However, the Regulation (EC) No 44/2001 went further and established the requirement of the decision to be "manifestly contrary to public policy"[49], reinforcing the principle of the free movement of judges. The Brussels I Regulation kept this wording in its article 45.

The public policy exception was addressed for the first time by the European Court of Justice in the case *Hoffmann v. Krieg*[50] where the court was asked to decide on whether a German decision establishing the obligation to make maintenance payments to a spouse could be recognized in the Netherlands. In the decision, the court emphasized the subsidiary nature of the public policy exception, stating that "*the public-policy clause, which 'ought to operate only in exceptional cases [...]*"[51]. However, the decision of the court was not grounded on the public policy exception since there were other grounds for non-recognition that were applicable to the situation.

Thus, it was only in *Krombach v. Bamberski*[52], twelve years later, that the European Court of Justice had the opportunity to apply the public policy exception. A careful weighing of, on one hand, the Brussels I Convention and the free movement of judgements and, on the other, the fundamental rules and principles of a certain legal order had to take place. In order to establish the threshold for triggering the public policy exception the court had to define what principles and values to attend. Anticipating a topic that will be addressed further ahead in

[48] Article 27/1 of Convention on Jurisdiction and the enforcement of judgements in civil and commercial matters [The 1968 Brussels Convention].
[49] Article 34/1 of the Regulation (EC) No 44/2001.
[50] Case C-145/86 *Hoffmann v. Krieg* [1988] ECR 645.
[51] Idem, paragraph 21.
[52] Case C-7/98 *Krombach v. Bamberski* [2000].

this chapter, this raises the question of what should be the content of the public policy exception. Should it be filled with national principles and values or should it go one step further and evolve to a European notion? Should the exception be based on domestic public policy or on international public policy?

The answers to these questions started to come up in the *Krombach v. Bamberski* decision. The case concerned a German doctor, Mr. Krombach, who was accused of killing a French girl in Germany. The French court considered itself competent due to the nationality of the victim and ordered Mr. Krombach to appear before the court. The doctor did not attend the judgement since he was afraid to be arrested and the decision was rendered without him being heard. Krombach was sentenced to 15 years of imprisonment. Together with the criminal proceedings, the French civil court also ordered the payment of compensation to the parents of the victim. When the family sought the recognition of that order in Germany, Krombach appealed to the Bundesgerichtshof (the Federal Court in Germany) reasoning that he had not had the chance to defend himself in the trial in France.

Called to decide on whether demanding the presence in person of the defendant in order for his defence to be presented could be considered a violation of the fundamental principles of German legal system that would trigger the application of article 27 of the Brussels Convention, the court stated that "[…] *the infringement would have to constitute a manifest breach of a rule of law regarded as essential in the legal order of the State in which enforcement is sought or of a right recognised as being fundamental within that legal order*"[53]. By highlighting the importance of the right to a defence as a cornerstone of a fair trial, the court established the first threshold for triggering the public policy exception that indeed corresponds to a fundamental right predicted in article 6 (Right to a fair trial) of the European Convention on Human Rights.

Furthermore, the court also concluded that it is the court of the state where the recognition is sought that has the competence to define the content of the public policy exception as well as its limits. However, it is for the European Court of Justice to review the limits based on which the court refused the recognition of a judgment.[54]

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[53] Case C-7/98 *Krombach v. Bamberski* [2000] paragraph 37.
[54] Idem, paragraph 22.

The court also addressed this question in *Régie Nationale des Usines Renault SA v. Maxicar and Formento*[55], where Mr. Fomento and Maxicar were held liable in France for unlawfully manufacturing and marketing parts for Renault vehicles. The question arose when Renault tried to enforce the decision in Italy where the industrial property rights in spare parts does not exist. Thus, the Italian court felt the need to refer to the European Court of Justice the question whether the decision of the French Court violated the free movement of goods and the freedom of competition established under EU law. Firstly, the judges stressed the conclusions reached by the previous case law, namely that the public policy exception should be interpreted strictly and that it should only be applicable in exceptional cases[56]. Secondly, they applied these principles to the situation at hand, stating that "*The court of the State in which enforcement is sought cannot, without undermining the aim of the Convention, refuse recognition of a decision emanating from another Contracting State solely on the ground that it considers that national or Community law was misapplied in that decision*."[57]

There are other cases that could be dealt with in this chapter[58]. However, the aforementioned case law gives us a clear picture of the content and application of the public policy exception. Summing up, it became clear that the public policy exception can only be invoked in exceptional cases when there is a manifest breach of a fundamental rule of law of a certain legal order.

Taking these considerations in mind, we are now in a position to understand that the public policy exception cannot be triggered when some specificities or particularities of a legal system are at stake. That would absolutely frustrate the purpose of the Brussels I Regulation. Thus, it cannot have a direct correspondence with the domestic legal order. In order to assess the content of this exception, it is required to go one step further and place it at the European level. Hence, only a violation of a fundamental principle shared by all the member states could be considered the threshold for triggering the public-policy exception[59] as was the case in *Krombach v. Bamberski* decision. These common values are described in the European Convention on Human Rights and in the Charter of Fundamental Rights of the European Union, legal instruments that comprise the "*common heritage of political traditions, ideals,*

[55] Case C-38/98 *Renault v Maxicar* [2000].
[56] Idem, paragraph 26.
[57] Case C-38/98 *Renault v Maxicar* [2000] paragraph 33.
[58] Case C-420/07 *Apostolides v. Orams* [2009] or *Canada Trust Company v. Stolzenberg and Gambazzi and others* [2000].
[59] This was precisely the position of the ECJ in *Krombach v. Bamberski.*

freedom and the rule of law"[60] of all Member States. Indeed, the European Union is a legal community based around the same fundamental values. Therefore, it is likely that the content of public policy is similar in the Member States and the exception is rarely used.[61]

Nevertheless, there are situations where the question may arise and the validity of interest rate swap contracts according to the Portuguese law is one of them. Despite the fact that this thesis is focused on the Banco Santander Totta decision and therefore in interest rate swap contracts, the conclusions reached are applicable to all financial derivative contracts.

c. The public policy exception and the Banco Santander Totta decision

In the Banco Santander Totta case, the defendants claimed that the interest rate swap contracts violated mandatory provisions of Portuguese law, which would lead to the application of article 3 (3) of the Rome I Convention. In chapter IV, we came to the conclusion that there were international elements that place these contracts outside the scope of article 3 (3). Hence, it would not be necessary to address the question on whether mandatory provisions of Portuguese law were violated by the contracts. However, the High Court of Justice in the Banco Santander Totta decision felt the need to express its views on the topic.

It is not my intention in this chapter to explore the topic of mandatory provisions of the Portuguese legal order that cannot be derogated by agreement in light of article 3 (3) of the Rome I Regulation, as the decision does so. Conversely, I intend to use the court's conclusions to address the issue of the public policy exception under Article 45 of the Brussels Regulation. This question never arose in this case since Banco Santander Totta and the Portuguese Government came to an agreement regarding these contracts. Thus, the decision will not be recognized and enforced in Portugal[62]. However, if this deal had not been struck, the discussion concerning the obstacles to the recognition and enforcement of the decision of the High Court of Justice in Portugal would come up. Who knows whether this was not considered when taking the decision to settle for a deal.

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[60] Preamble of the European Convention on Human Rights.

[61] Study on the Interpretation of the Public Policy Exception as referred to in EU Instruments of Private International and Procedural Law made by Directorate General for Internal Policies, Policy Department C: citizens' rights and constitutional affairs legal affairs, p. 7 and 8.

[62]https://www.reuters.com/article/portugal-santander-swaps/portugal-santander-agree-to-end-litigation-over-swaps-idUSP4N1BB024.

The question on whether interest rate swap contracts violate the prohibition of games of chance and/or constitute an abnormal change of circumstances is much debated and very controversial in Portugal. The purpose of this thesis is to build a legal framework of the several obstacles these contracts may face, which requires, in this chapter, two levels of analysis. Firstly, an answer to the question on whether Portuguese law is being violated by these contracts has to be provided. Secondly, even if we came to the conclusion that interest rate swap contracts indeed violate the prohibition of games of chance and/or constitute an abnormal change of circumstances, these provisions have to integrate the concept of public policy in order for article 45 of the Brussels Regulation to be triggered.

i. The abnormal change of circumstances

According to article 437 of the Portuguese Civil Code:

1- 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 termination of the contract or to modify it in accordance with principles of equity if fulfillment of that party's obligations under the contract would be a serious breach of the principles of good faith and if the abnormal changes do not form part of the risks covered by the contract.

Derivatives, namely interest rate swaps, became a popular financial instrument before the financial crisis of 2007 - 2008. For instance, in the United Kingdom between 2001 and 2007, 28.000 interest rate swaps were sold to small businesses[63]. In June 2013, the gross value of the interest rate swaps market was estimate to be of US$13.6 billion according to the Bank for International Settlements.[64] However, due to the financial crisis, interest rates dropped unexpectedly to near zero, which "*turned the interest rate swaps into consistent losers for the parties who had the fixed rate, as each term ended with the LIBOR or the index rate below the fixed rates. The inverted effect of this was a windfall for the institutions holding the floating rate.*"[65] This scenario led the parties who had the fixed rate under the contracts (the

[63] Matt Scuffham & Myles Neligan, *Special Report: UK Banks Face Scandal Over Toxic Insurance Products*, REUTERS, http://www.reuters.com/article/2012/08/22/us-banks-insurance-idUSBRE87L09E20120822, archived at http://perma.cc/U4AX-UZYG.

[64] Paulo Mota Pinto, *Contrato de swap de taxas de juro, jogo e aposta e alteração das circunstâncias que fundaram a decisão de contratar* (Revista de Legislação e Jurisprudência, ano 143, n.º 3987, July/August 2014), p. 391.

[65] Zachary Ahonen, *The Recent Financial Crisis and its Impact on Interest Rate Swaps: A Road to Recovery Through The Frustration Of Commercial Purpose Doctrine*, (available in http://journals.iupui.edu/index.php/iiclr/article/view/18272/18367).

counterparties to the banks) to seek the invalidity of these agreements before the courts grounded, among other arguments, on the abnormal change of circumstances.

The debate taking place in the Portuguese courts is based on two questions: *i)* is the unpredictable change to interest rates and its maintenance at such low rates since the second quarter of 2009 an abnormal change of circumstances? and *ii)* is that change a risk covered by the contract? Since this is not the core topic of this thesis, an overall view of the case law will be provided but the topic cannot be addressed in any depth.[66]

In providing answers to these questions, the courts do not have a harmonized opinion. However, a clear trend that considers the change to interest rates an abnormal change of circumstances that is not covered by the risks of the contract can be observed[67]. These decisions state that the abrupt and pronounced fall of the interest rates as a consequence of the financial crisis of 2007 - 2008 was an exceptional and unpredictable situation that had a direct impact on the interest rate swap contracts that suddenly became unbalanced. In a three-month period, the party who had the fixed rate suffered a considerable lost that was not covered by the risks of the contract. Consequently, maintaining the contracts would be contrary to general 'bona fide' principles, as the parties would not usually have foreseen such a high risk of financial loss at the moment they entered into the agreements.[68]

The case law that supports the argument that the fall in interest rates does not constitute an abnormal change of circumstances grounds its view on the fact that this risk was covered by the agreement.[69]

As was mentioned before, the High Court of Justice in the Banco Santander decision had the opportunity to reflect on this topic, coming to the conclusion that "*there has been a profound change in the macro-economic circumstances on which the parties based their decision to enter the swaps. Applying the test in Art. 437 of the Civil Code, the court accepts their submission that the global financial crisis constitutes an «abnormal change of*

[66] To see literature's opinions on this topic, read Paulo Mota Pinto, *Contrato de swap de taxas de juro, jogo e aposta e alteração das circunstâncias que fundaram a decisão de contratar and* Lebre de Freitas, *Contrato de Swap Meramente Especulativo, Regimes de Validade e de Alteração de Circunstâncias* (R.O.A., Ano 72, Vol. IV October/December, 2012, Lisbon).

[67] Cf. Ac. STJ 10.10.2013, Process nº 1387/115 TBBCL.G1.S1 (Granja da Fonseca); Ac. TRL 8.5.2014, Process nº 531/11.7 TVLSB.L1-8 (Ilídio Sacarrão Martins) and Ac. TRL 28.4.2015, Process nº 540/11.6TVLSB.L2-1 (João Ramos de Sousa)

[68] Cf. Ac. STJ 10.10.2013, Process nº 1387/115 TBBCL.G1.S1 (Granja da Fonseca)

[69] Cf. Ac. TRL 15.01.2015, Process nº 876/12.9TVLSB.L1-6 (Manuela Gomes); Ac. TRL 2.7.2015, Process nº 2118-10.2TVLSB.L1.-2 (Maria José Mouro) and Ac. TRL 10.05.2016, Process nº 1246/14.0T8PDL.L1-7 (Luís Espírito Santo).

circumstances»".[70] When addressing the question of whether the risk was covered by the swap contracts, the court answered negatively.[71]

ii. Prohibition of games of chance

Article 1245 of the Portuguese Civil Code provides that

Games and betting are not valid contracts and do not give rise to civil obligations; however, when lawful, games of chance give rise to natural obligations, except where by other motives they shall be deemed void or voidable pursuant to the general law, or, if the creditor has committed fraud in its execution.

In light of this provision, a lot has been written about the possibility of interest rate swap contracts violating the prohibition of games of chance. Despite the dissenting opinions[72], there is a clear majority, both in the literature and in the courts, that supports the opinion that interest rate swap contracts are not a game of chance. Summing up their arguments, it is firstly observed that an interest rate swap contracts is not exclusively dependent on luck or a fortuitous event, but rather on a projection based on studies regarding the evolution of a certain interest rate[73]. Moreover, it is also underlined that if a party to an interest rate swap contract enters into this agreement to hedge its exposure to the variation of a certain interest rate, it is because the risk already exists. Thus, the swap contract does not create a risk but rather aims to reduce or mitigate a risk that already exists.[74] Furthermore, it was the parties' intention to enter into a financial instrument, traded in capital markets and whose clauses were previously defined (most of the times under the ISDA Master Agreement), which clearly

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[70] The Banco Santander Totta decision, paragraph 617.

[71] Idem, paragraph 634.

[72] Lebre de Freitas, *Contrato de Swap Meramente Especulativo, Regimes de Validade e de Alteração de Circunstâncias* (R.O.A., Ano 72, Vol. IV October/December, 2012, Lisbon), p.949, arguing that interest rate swap contracts are a game of chance when they are merely speculative and Ac. TRL de 21-03-2013, Process n. º 2587/10.0TVLSB.L1.6 (Ana Azeredo Coelho) stating that if the contract does not cover a specified risk (e.g. another loan), it is a betting contract. The same is supported by Hélder M. Mourato, *Swap de Taxa de Juro: A Primeira Jurisprudência* (Cadernos do Mercado de Valores Mobiliários, n. º44, April 2013, Lisbon), stating that in order for a swap contract to be valid, it has to constructed as an hedging instrument.
Against this understanding, stressing the autonomy of the swap contracts: Ac. STJ de 11-02-2015, Process n. º 309/11.8TVLSB.L1.S1 (Sebastião Póvoas) and Ac. TRP de 28-10-2015, Process n.º 27/14.5TVPRT.P1 (Sousa Lameira).

[73] Ac. STJ de 29-01-2015, Process n. º 531/11.7TVLSB.L1.S1 (Bettencourt De Faria) that ends up considering the contract void due to its pure speculative nature that in court's opinion violate the public order.

[74] Ac. STJ de 11-02-2015, Process n.º 309/11.8TVLSB.L1.S1 (Sebastião Póvoas).

sets this apart from the gambling regime.[75] Additionally, while the speculation in the swap contracts is anchored on an economic purpose, games of chance are usually driven by irrational motivations, lacking an economic rationale[76].

Two other arguments objecting to the application of the gambling regime are presented in a court's decision.[77] On the one hand, it is stated that the swap contracts are regulated by the Portuguese Securities Code (article 2), which *per se* makes it impossible to apply article 1245 of the Civil Code[78]. On the other, the speculation, usually rejected by the Portuguese legal system (this is the rationale behind article 1245), is justified in financial markets due to its commercially legitimate purposes, while the speculation in gambling activities does not have any purpose.

Lastly, the authors highlight that the context, structure and aim of swap contracts and games of chance should not be confused. The latter is associated with entertainment and leisure.[79] Furthermore, in the gambling activity, both the parties have the intention to bet[80], whereas in swap contracts it is difficult to imagine that a financial institution that operates professionally in the derivatives market shares that intention[81].

The High Court of Justice in the Banco Santander decision expressed its opinion on this topic stating that "*the swaps were not betting or gaming and are not invalidated on this ground"*[82].

d. Are there grounds to challenge the recognition and enforcement of the Banco Santander Totta decision in Portugal?

Thus far, we have come to two conclusions: *i)* the recognition and enforcement of a decision may be challenged based on the public policy exception as long as fundamental values shared by all the Member-States are being violated; *ii)* despite the lack of unanimity on this topic, it

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[75] Ac. TRL de 15-01-2015, Process n.º 876/12.9TVLSB.L1.6 (Manuela Gomes).

[76] Ac. TRL de 08-05-2014, Process n.º 531/11.7TVLSB.L1.8 (Ilídio Sacarrão Martins).

[77] Ac. TRL de 13-05-2013, Process n.º 309/11.8TVLSB.L1.7 (Maria do Rosário Morgado).

[78] This opinion is shared by Ac. STJ de 11-02-2015, Process n.º 309/11.8TVLSB.L1.S1 (Sebastião Póvoas) and by the High Court of Justice in Banco Santander Totta decision, paragraph 453 (2) – "*The swaps fall within the remit of the Securities Code, and thus outside the scope of Art. 1245 by virtue of Art. 1247*."

[79] Pedro Boullosa Gonzalez, *Interest Rate Swaps: Perspectiva Jurídica* (Cadernos do Mercado de Valores Mobiliários, n.º44, April de 2013, Lisbon), p. 10 and 21.

[80] Clara Calheiros, *O Contrato de Swap no Contexto da Actual Crise Financeira Global* (Cadernos de Direito Privado, N.º42.º, August, 2013, Braga, Coimbra Editora), p.8.

[81] Paulo Mota Pinto, *Contrato de swap de taxas de juro, jogo e aposta e alteração das circunstâncias que fundaram a decisão de contratar* p. 413.

[82] The Banco Santander Totta decision, paragraph 453 (1).

is firmly arguable that the financial crisis of 2007 - 2008 and the consequent drop in interest rates is sufficient grounds for seeking the invalidity of the interest rate swap contracts under the abnormal change of circumstances provision. The same cannot be said regarding the prohibition of games of chance since the argument is much less stronger.

Therefore, one last answer has to be provided in order to close our reasoning – is the abnormal change of circumstances part of public policy, what would trigger the exception provided in article 45 a) of the Brussels I Regulation?

A similar question was addressed by the High Court of Justice in the Banco Santander decision and the conclusions reached are of use for this thesis. Hence, the experts and the judge shared their opinions on whether article 437 is a mandatory provision of Portuguese law. Only if the answer is positive can we take another step and state that indeed it is part of public policy.

Once again, the authors have not reached a common understanding on this topic. Thus, Manuel Carneiro da Frada supports the mandatory nature of article 437 grounded, among other arguments, on "*the underlying rationale of the provision (as preventing substantively unfair situations, which would otherwise be contrary to good faith)*"[83] Furthermore, Pedro Pais de Vasconcelos states that, even though we can only resort to article 437 when there is not a contractual solution, "*article 437 does not cease to be mandatory*"[84].

Nevertheless, equally reputable professors have the opposing view. Paulo Câmara proposes several arguments[85] that justify the non-mandatory nature of the provision. Moreover, Mário Júlio de Almeida Costa reaches the same conclusion by arguing that the parties have the possibility to waive or limit the application of article 437, which makes it a non-mandatory rule.[86]

This brief over-view of the literature's position regarding the nature of article 437 allows us to proceed on our reasoning. If it is arguable that the abnormal change of circumstances is a mandatory provision of the Portuguese legal system, there is room to ask whether that institute can trigger the public policy exception.

[83] The Banco Santander Totta decision, paragraph 496.
[84] Idem, paragraph 489 (1).
[85] Idem, paragraph 498.
[86] Mário Júlio de Almeida, *Direito das Obrigações* (Almedina, 2009) p. 341.

It is my belief that if authors had been faced with this question, they would answer it in different ways due to the contrasting opinions we have been exposing throughout this thesis. In order to come to the conclusion that a decision of a foreign court concerning interest rate swap contracts would not be recognized in Portugal by virtue of the public policy exception, multiple "yesses" would have to be provided. Yes, interest rate swap contracts entered into before the financial crisis of 2007 - 2008 would be subject to the abnormal change of circumstances; yes, article 437 is a mandatory provision of our legal order and, finally, yes, this provision is part of the fundamental values of our legal system.

My understanding is that the financial crisis of 2007 - 2008 must be considered an abnormal change to the circumstances under which the parties have concluded the agreements. The drop in interest rates was unpredictable and created an extremely unbalanced situation whose risk was not covered by the contracts. Moreover, I also share Professor Carneiro da Frada's view on the nature of article 437, supporting that it is a mandatory provision of the portuguese legal system since the waiver or limitation of the application of this provision can only take place concerning known risks but it does not apply to unknown risks. Hence, the application of article 437 cannot be fully excluded[87]. Nevertheless, I find it hard to argue that fundamental values of the Portuguese legal order are at stake.

The public policy exception established in Brussels Regulation I can only be balanced with the free movement of decisions, a fundamental principle of European Union law, if a narrow interpretation of the public policy concept is adopted. In light of this reasoning, and despite knowing that article 437 safeguards the "bona fide" principles, a cornerstone of the Portuguese legal system, I believe there is no grounds to trigger the public policy exception. The is a principle spread throughout several provisions of the Portuguese legal system but despite its importance, it would be indefensible to support that all of them constitute a sufficient ground to seek the non-recognition of a decision. Therefore, we need to go further in what concerns the level of importance of the value that is safeguarded by the provision in order to support that it integrates the notion of public policy. That step can only be taken in light of the European instruments protecting human rights. Hence, in order to come to the conclusion that the public policy exception would be triggered in this situation, fundamental values protected by the European Convention on Human Rights and by the Charter of

[87] The Banco Santander Totta decision, paragraph 497.

Fundamental Rights of the European Union would have to be violated by the interest rate swap contracts and I do not believe that is the case.

In summary, as long as a European and constitutional notion of public policy is adopted, as it is my view, the Banco Santander Totta decision would not face any obstacle when recognized in Portugal.

VI. Conclusions

It was my goal in this thesis to address two legal obstacles a dispute before a foreign court on interest rate swap contracts could face.

The first obstacle is originated in article 3 of the Rome I Regulation. In order to be able to fully comprehend it, previous knowledge on the derivatives market had to be acquired. Hence, the content of ISDA Master Agreement was explored since the majority of the transactions nowadays are made with this documentation. Special emphasis was given to the Governing Law and Jurisdiction clause since it was due to the choice made in this clause that the first obstacle came up.

When studying the ISDA Master Agreement, we came across the fact that the parties have the possibility to choose between English law and the law of the State of New York. That practice is called “forum shopping” and is grounded on the principle of freedom of choice. Nevertheless, it has its limits and the first obstacle detailed on this thesis is one of them. I refer to article 3 (3) of the Rome I Convention.

Indeed parties are free to choose the law governing their contracts and that is the common practice in swap contracts, including in single country agreements, where often the choice determines English law as the competent law. Nevertheless, according to article 3 (3) of the Rome I Regulation, that choice cannot waive the mandatory provisions of the legal system that all the relevant elements to the agreement are connected with. On the one hand, in domestic contracts, with exception to the governing law clause, all elements point to the country where the parties are incorporated in and have their business. On the other, one could argue that there are elements that internationalize the agreements, putting it outside the scope of article 3 (3), such as, among others, the use of the ISDA Master Agreement.

In that regard, the High Court of Justice of England and Wales was called upon to decide on whether article 3 (3) of the Rome I Convention should be relied upon in domestic swap agreements and determine the application of the mandatory provisions of the domestic law that could not be derogated by contract. It provided two different answers.

In Dexia, the court came to the conclusion that in order for an agreement to be placed outside the scope of article 3 (3), its relevant elements had to point to a concrete jurisdiction other than the domestic one, in that case Italy. Therefore, it was not enough that the elements connect the agreement with the "international sphere"; a concrete connection to a foreign jurisdiction was required.

The court had a chance to reflect again on what seems to have been an excessively broad interpretation of the provision, incompatible with party autonomy and with the derivatives market itself and the legal certainty it entails. That opportunity came with the Banco Santander decision, an equal situation where interest rate swap agreements had been entered into by Portuguese parties that have designated English law as its governing law. Claims that these contracts violated provisions of Portuguese law led the court to decide on whether this was a purely domestic agreement or if its elements internationalize it. Despite being located in a common law system where the rule of precedent has major importance, the court overturned Dexia and provided an all-new interpretation of article 3 (3) of the Rome I Regulation, where it was no longer required that the elements of the agreement connect it with a specific jurisdiction. The court assessed several elements, among which I highlight the possibility to assign the contractual positions, the use of the ISDA Master Agreement and the conclusion of back-to-back swaps with foreign entities, to come to the conclusion that they place the agreement outside the domestic legal order, rendering it out of scope of article 3 (3). Hence, the mandatory provisions of Portuguese law do not affect the choice of the governing law.

The second obstacle addressed in this thesis comes up later in a timeline of a foreign decision concerning interest rate swaps agreements and it is related with its recognition and enforcement in Portugal. It is grounded on article 45 of the Brussels I Regulation that allows for the refusal of the recognition of a judgement based on the public policy exception.

In order to assess how this provision could be an obstacle to foreign decisions on swap contracts, several steps had to be taken. Firstly, the concept of public policy was defined. A review of the relevant case law was provided, as well as a critical analysis, in order to reach the conclusion that this notion has to be filled with European and constitutional values. In

order for the free movement of decisions to be preserved, only a violation of a fundamental principle shared by all member states can be considered the threshold for triggering the public-policy exception.

Secondly, the public policy exception could only be raised if there was a violation of the Portuguese law by these agreements. Thus, we discussed whether interest rate swap agreements could qualify for an abnormal change in circumstance in light of article 437 of the Portuguese Civil Code and/or violate the prohibition of games of chance stated in article 1245. Despite the lack of unanimity among the literature and case law, it is defensible that the financial crisis of 2007 – 2008 represents an abnormal change of the circumstances under which these contracts were concluded.

Furthermore, another step had to be taken in order to trigger the public policy exception in the recognition of the decision: the abnormal change of circumstances provision has to integrate public policy. At this point is where I believe this line of reasoning breaks. According to the concept of public policy supported by this thesis, fundamental values protected by European instruments would have to be violated by this decision to trigger the public policy exception and I believe this is not the case. The ”bona fide” principles safeguarded by this rule are important components of the Portuguese legal system, but if we fill the notion of public policy with the particularities of each domestic legal order, this exception would be too frequently raised and the free movement of decisions jeopardized.

Taking everything into consideration, two material obstacles to disputes concerning interest rate swap contracts before foreign courts were presented. The interpretation provided by the Banco Santander Totta decision reduces the risk of the application of mandatory provisions of the law the agreement has the closest connection with. As for the second obstacle, namely the recognition and enforcement of a decision regarding interest rate swaps in Portugal, it is more difficult to predict since there are different views on the several assumptions required to come to the conclusion that the public policy exception can be raised. We will have to wait for a similar decision to be recognized and enforced in Portugal to gain more valuable insight on the topic.

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