



BANKING AND FINANCE LITIGATION

THE TERMINATION OF SWAP AGREEMENT BECAUSE OF A CHANGE IN CIRCUMSTANCES

THE RECENT JUDGMENT OF THE SUPREME COURT OF JUSTICE

In analysing the case, the Supreme Court of Justice held that, despite being wagering agreements, swap agreements are still covered by the provisions of article 437 of the Civil Code.

In a recent judgment in a legal action took by a company against a bank, the Supreme Court of Justice readdressed the question of whether an “abnormal change in circumstances” under article 437 of the Civil Code applies to swap agreements. In particular, the Court considered whether the concept applied to interest rate swap agreements, as wagering agreements in which the risk assumed by the parties is the essential characteristic of the agreement.

In this case, among other things, the company asked the Court to declare the termination of the interest rate swap agreement it had made with the bank. The company grounded its request on an unforeseeable and abnormal change in circumstances as provided for in article 437 of the Civil Code – a change arising from the rapid fall in the rates of interest indexed to Euribor following the financial crisis of October 2008, after the financial giant Lehman Brothers went bust.

The first instance court and the Court of Appeal found in favour of the claimant company and declared the termination of the swap agreement in question. When two judgments have been handed down with the same result and on the same grounds, this usually prevents any appeal to the Supreme Court of Justice. However, the court accepted the exceptional review appeal, because it held that question raised was both very complex and very controversial.

In analysing the case, the Supreme Court of Justice held that, despite being wagering agreements – whose performance vary depending on changes in the reference agreed between the parties (in this case, the Euribor), i.e., uncertain future events – swap agreements are still covered by the provisions of article 437 of the Civil Code.

According to the Supreme Court of Justice, the rules on terminating (or modifying) contracts with grounds in an abnormal change in circumstances apply to any contract, including those that involve a high degree of exposure to risk, or even those that have risk their subject matter, as is the case with the interest swap agreements at issue in this case.

However, for the contract to be terminated (or modified) it is necessary for the change in circumstances to occur in a context other than that of the risks that are part of the contract itself and which are, for this reason, provided for and assumed by the parties when they sign the contract.

As a consequence, according to the Supreme Court of Justice, if the abrupt falls in Euribor rates, as a consequence of the 2008 financial crisis, are capable of making the contractual object of the parties are unviable, it may be concluded that those falls in the rates – because of their enormous and serious impact on the purpose of the contract – not only fell outside the circumstances on which the parties based their decision to contract, but they should also be held to be outside the risk of the contract itself.

In these cases, if it is demonstrated that there is a worsening of the financial situation of the company, or harm to it that is clearly disproportionate in relation to the cost to the bank arising from the termination, that harm may be considered contrary to the principles of good faith and, therefore, give rise to the termination of the swap agreements because of abnormal change in circumstances.

The Supreme Court of Justice found that the abrupt fall in the Euribor reference rates in the context of the 2008 financial crisis represented an abnormal change in circumstances in this case. However, the Court ultimately held that the claimant had not demonstrated the existence of serious harm with the maintenance of the swap agreement. Specifically, the claimant had not demonstrated the size of the losses suffered by it in terms of its financial indebtedness and for this reason, the Court decided to overturn the decisions held by the first instance court and the Court of Appeal, and to dismiss the proceedings against the bank.

This is an important decision of the Supreme Court of Justice. First, it confirms the understanding that the rules on termination of contracts because of an abnormal change in circumstances apply to swap agreements. Second, it confirms that the abrupt fall in the Euribor reference rates in the context of the 2008 financial crisis give the injured party the right to apply for termination of the agreement as long as the other requirements set out above also verify. However, in the case at hand, those requirements were not fully met, as we have explained.

Nevertheless, it is not yet possible to conclude that this judgment brings full clarification or foreseeability to the case law of the Supreme Court of Justice in respect of this matter which, as we know, has been very divided. In fact, the judgment in question was not voted for unanimously by all the judges making up the panel to which the case was distributed, which is a clear demonstration that the Supreme Court remains divided regarding this issue. Judge Abrantes Galdes voted against the majority because he held that, although the termination or modification of swap agreements because of an abnormal change in circumstances could not be absolutely excluded, the criterion for termination or modification must be stricter than the one applied to contracts that have no speculative or risk element. Judge Abrantes Galdes thus held that the impact of the 2008 financial crisis on the Euribor rate and on the financial flows of the agreement in question did not, in this case, translate into an abnormal change in circumstances.

Despite the undeniable importance of this judgment, there is no doubt that the direction of the case law of the Supreme Court of Justice remains uncertain. In view of the intrinsically risky nature of interest rate swap agreements – in which the variation in reference rates is part of the very nature of the agreement – we believe that the more restrictive interpretation of termination of the contract with grounds on an abnormal change in circumstances, as put forward by Judge Abrantes Galdes, is the most appropriate one. Nevertheless, we will have to wait for future decisions to see the point at which the case law of the Supreme Court of Justice becomes stable.

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