Portuguese Supreme Court rules against the characterisation of speculative interest rate swap agreements as illegal gambling

Judgment of the Supreme Court of 11 February 2015 (case no. 309/11)

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The possible characterisation of speculative interest rate swaps as illegal gambling has been a topic of heated discussion in the Portuguese high courts in recent years. The judgment of the Portuguese Supreme Court of 11 February 2015 (Case no. 309/11) represents one step further in this discussion by ruling against the invalidity of an interest rate swap agreement argued to be speculative.

The ruling concerns an agreement executed in 2008 between a Portuguese bank and a Portuguese limited liability company engaged in construction and real estate development (hereinafter, the "Company"), pursuant to which the Company swapped a variable 3-month Euribor rate for a fixed rate over a notional amount of approximately 5,5 million euros for a term of five years. In the course of the performance of the agreement, the Company allegedly suffered losses in excess of EUR 320,000.

The Company initially argued that the interest rate swap agreement was void because the Bank had failed to properly inform the Company of its content and had misled the Company to execute the agreement. The claim was dismissed by both the Court of First Instance and the Lisbon Court of Appeal. The Company lodged an appeal with the Supreme Court based on the existence of a contradictory ruling of the Lisbon Court of Appeal on an identical point of law.

Before the Supreme Court, the Company contested the validity of speculative interest rate swap agreements under Portuguese law with a view to having the disputed agreement held null and void. The petition was based on the inexistence of a correlation between the debt held by the Company (mostly short-term loans close to maturity and with a fixed interest rate) and the terms of the interest rate swap agreement entered into with the bank (with a longer term and based on a variable 3-month Euribor rate). This would allegedly lead to the conclusion that the purpose of the agreement was not hedging, but rather speculating on the fluctuation of interest rates. The Company submitted that this would give rise to the application of the rules on gambling (*jogo e aposta*) contained in the Civil Code, which determine the invalidity of agreements that are entirely dependent on luck (as opposed to those in which skills or expertise play a part).

The Supreme Court disagreed with the reasoning made by the Company, replying that interest rate swaps typically have one of three purposes, all of which are equally admissible in the eyes of the law: reducing the risk of interest rate fluctuations, obtaining a better interest rate or speculating on the fluctuation of such rate. The ruling adds that speculation is a legitimate objective which cannot be confused with the typical motivation of gamblers that usually has a recreational component. Speculation brings liquidity to the market and is essential to allow hedgers to mitigate risk. The Court quotes David Megle, in "The Economic Role of Speculation", ISDA, Research Notes, No. 2, 2010, saying that "without speculation markets would be less complete in that there would be fewer opportunities for other market participants, especially hedgers, wishing to manage the risks they encounter in their financial activities".

The Supreme Court further contends that speculative swaps are envisaged and allowed by Regulation (EU) no. 549/2013 of the European Parliament and of the Council of 21 May 2013 on the European system of national and regional accounts in the European Union,

which states that "financial derivatives are used for a number of purposes including (…) speculation". Also Regulation no. 2/2002 of the Portuguese Securities Market Authority and Decree-Act no. 357-A/2007, dated 31 October 2007, implementing the Markets in Financial Instruments Directive 2004/39/CE, acknowledge interest rate swaps based on a notional or theoretical principal value, i.e., which are not entered into in connection with an underlying agreement (typically, a loan). Interest rate swaps are nowadays frequently executed without having the direct purpose of hedging interest rate fluctuation risks, but rather that of fixing the costs of financing (or manage financial risk). The ruling adds that there can be no doubt as to the legality of interest rate swaps regardless of whether the underlying asset is real or merely notional (nominal, fictitious or hypothetical) in view of the European Union law principle requiring implementing laws to be interpreted harmoniously and in conformity with the EU law that is being implemented[1].

The Court further understood that the fact that interest rate swaps are governed by special national and European Union legislation sets aside the application of the rules on gambling under the Civil Code, which are based on concepts that are regarded as obsolete by the Court.

The ruling ends by saying that inequality in the position of the parties (alleged by the Company) does not give rise, on its own, to the invalidity of the agreement, but may rather support its early termination, provided that the applicable requirements are met and that this is expressly requested by the aggrieved party. This is, in our view, a reference to the legal regime of change in circumstances (*rebus sic stantibus*), which has underpinned several decisions of Portuguese courts determining the termination of interest rate swaps due to the drop in interest rates during the financial crisis[2].

Curiously, this ruling of the Portuguese Supreme Court was given only thirteen days after a previous decision of the same court had ruled precisely in the opposite direction (Judgment of the Portuguese Supreme Court of 29 January 2015). In this earlier case the court characterised certain interest rate swap agreements as speculative and held them null and void for being contrary to public policy. The court argued that speculation *per se* may not be deemed a relevant motivation from an economic perspective and is unworthy of being protected by the law.

Although the circumstances on which each of the decisions is based are not entirely identical, the existence of two contradictory decisions of the Supreme Court concerning the same point of law means that an appeal applying for case law uniformity (*recurso extraordinário de unificação de jurisprudência*) may be lodged. Thus it seems that the last stone is yet to be placed in relation to the speculative interest rate swaps vs. gambling controversy.

[1] The ruling quotes CALVÃO DA SILVA, in "Swap de taxa de juro: a sua legalidade e autonomia e inaplicabilidade da exceção de jogo e aposta", RLJ no. 3979, May-April 2013, 262-263.

[2] *Vide* http://www.gomezacebo-pombo.com/index.php/en/knowledge/legal-analysis/item/1330-portugal-supreme-court-rules-termination-of-interest-rate-swap-agreement-based-on-change-in-circumstances-due-to-the-drop-in-interest-rates-during-the-financial-crisis.