The current state of case law regarding the (in)validity of swap contracts

Ángel Carrasco Perera
Professor of Civil Law, Universidad de Castilla-La Mancha
Academic Counsel, Gómez- Acebo & Pombo

Half of the appeals heard and determined by the Civil Division of the Supreme Court concern swap-related disputes. In the midst of this much case law, it is the purpose of this briefing note to compile a list of decision criteria, typically contrary to the financial institution.

1. Introduction: the judicial 'boom'

At the very least, half of the judgments given by the Civil Division of the Supreme Court in 2016 and 2017 concern the validity (or invalidity) of swap contracts. A striking proportion that gives an idea of the cassation-related business that mostly occupies the court of last resort. On the basis of this enormous amount of judgments, it is possible to conclude without risk of erring that about 90% of these are against the financial institution and nullify the contract; between the end of October 2013 and July 2016, 64 rulings upholding invalidity vs 3 that did not uphold the same. This contrasts with the first line of case law (Judgments of the Supreme Court of 21.11.2012 and 29.10.2013) that ruled for the financial institutions based on the essential randomness of the product, an argument that has now fallen into disuse.

The introductory 'motto' of the current discourse has already become a boilerplate: "Numerous are the judgments of this court forming constant and consistent case law to which we adhere that consider that a breach of said legislation, mainly in respect of risk-related information, both in terms of the possibility of negative swap spreads and of high termination costs, allows for the presumption of mistake on the part of whoever contracted upon said lack of information". Invariably, such opening words are the prelude to a judgment upholding the invalidity of the swap contract at issue.

The aforementioned proportion is lower in provincial courts (*Audiencias*), overall less sympathetic with individual investors. This explains the number of judgments for cassation

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amounting to a proportion that is much higher than what is ordinary in other sectors of Private Law; which is highly inappropriate, since the evidence on the existence and scope of the mistake must have already been established at the lower court if, as admitted by the Supreme Court itself, "what matters is if the individual investor was sufficiently informed" as to the relevant issues, something that can hardly be determined by the mere application of dogma and abstract *rationes decidendi*.

Of the 10% of cases where invalidity is not upheld, in approximately half of these the reason behind the different determination is clear, insofar that the cases are highly prejudged in respect of the relevant facts, the provincial court establishing that the individual investor was "well informed" or an "expert" in the purchase of such products (e.g., Judgments of the Supreme Court of 20.12.2016, 15.2.2017 and 23.2.2017); other times the reason is not clear inasmuch as it relies on a criterion that is not normally taken into account in other judgments (e.g. Judgment of the Supreme Court of 24.3.2017: "balanced risk profile and could purchase medium risk products and had experience in this type of product: sufficient information about the characteristics of the product and its risks when the second swap was purchased, which is the only one that resulted in negative value settlements"). However, and as can be divined, even by the huge amount of material available, the judgments are not always consistent, and, except in a handful of cases, the criteria are not unquestionably certain.

2. Summary of criteria

Next we will build a list of criteria from which to anticipate the outcome of future lawsuits. Judgments will be cited on the understanding that more references could be made to the subject given the abundance of material.

1. All judgments that nullify the swap contract do so on the basis of a contractual mistake, not on a contravention of mandatory rules to be complied with in the purchase process. Although the odd judgment invokes a lack of reason for the contract (*causa*), illegality or voidness of the cost of termination clause due to indetermination, it is usually a secondary consideration, and the judgment, if it upholds the invalidity, does so by reason of a contractual mistake and nullifies the entire contract. None of the judgments address the problem through the *rebus sic stantibus* (unforeseeability and excessive hardship) clause. Curiosity: Only one mentions that the claim invokes the rebus clause, together with the relevant provisions of the Securities Market Act ("**LMV**"), but ultimately there is a finding of mistake on the grounds of a lack of supply of information on the foreseeable flow of interest (Judgment of the Supreme Court of 26.2.2015). If the claim addresses invalidity on the grounds of a lack of reason for the contract or illegality of the same, it is likely that the judgment will be against the claimant (e.g., Judgment of the Supreme Court of 24.11.2016).

2. The following is <u>no longer</u> legal doctrine of the Supreme Court: "A mistaken presupposition cannot be considered reasonably certain when the operation of the contract is projected on a more or less near future with a strong component of randomness, since the consequent uncertainty involves the assumption by contracting parties of a risk of loss and profit" (Judgment of the Supreme Court of 29.10.2013).

3. The necessary training to know the nature, characteristics and risks of a complex and risky product such as the swap is not that of the simple entrepreneur, not even if repeating, but that of a stock market professional or, at least, of a client experienced in this type of products (e.g., Judgments of the Supreme Court of 5.4.2017 and 6.4.2017), such as a risk analyst in a venture capital firm (Judgment of the Supreme Court of 16.2.2016), but it is not enough for the contractor to be an economist (Judgment of the Supreme Court of 30.10.2015) or a company tax advisor (Judgment of the Supreme Court of 13.1.2017). It is not enough, as some provincial courts have concluded (Judgment of the Madrid *Audiencia Provincial* (Twenty-fifth Chamber) of 18.12.2013), that the company has its own financial department. Neither can the specialist knowledge required in the purchase of this type of complex financial products "be deduced from the fact of having been in charge of dealings with banks for normal company business" (e.g., Judgment of the Supreme Court of 5.10.2016).

4. However, the management of two different standards of knowledge ("expert", "experienced purchaser") sometimes leads to inconsistencies between judgments.

5. The client's reading of the documentation and the failure to request additional clarification does not suffice to dispel the mistake. The bank must ensure that the client has come to understand the risk of benchmark interest rate fluctuations and the risk and amount of the cost of terminations. The bank's obligation is proactive rather than one of mere availability (e.g., Judgment of the Supreme Court of 6.2.2017).

6. The duty to inform impinging on the financial institution is not satisfied by a mere illustration of the obvious, that is, that a variable benchmark is established as a limit to the application of the fixed rate, that the result can be positive or negative for the customer according to the fluctuation of that benchmark rate, etc. A "supplementary information activity" is required (e.g., Judgment of the Supreme Court of 14.2.2017). A simple "understanding" of the clauses by the client is not enough (e.g., Judgment of the Supreme Court of 1.6.2016). It is not a question of the bank being able to guess future developments in interest rates but of providing the client with complete, sufficient and comprehensible information on the possible consequences of upward or downward fluctuations in interest rates and of the high costs of early termination (e.g., Judgment of the Supreme Court of 24.3.2017).

7. In essence, the treatment does not differ if the contract was entered into before or after the amendment to the LMV (2007) to incorporate the Markets in Financial Instruments Directive ("**MIFID**") (e.g., Judgments of the Supreme Court of 21.7.2016 and 24.11.2016). For the Supreme Court, the MIFID does not have its own substantiveness, neither in this nor in other areas.

8. Failure to carry out the assessments of appropriateness or suitability prescribed by MIFID means that there is an essential and excusable presumption of mistake (as of Judgment of the Supreme Court of 20.1.2014).

9. Mistake as regards the amount of the termination cost always produces an essential mistake (as of Judgment of the Supreme Court of 15.9.2015). The judgments that accept the claim

of invalidity by reason of mistake concerning the termination clause accept that its generic formulation prevents the claimant from having a precise idea of the cost that the termination could involve.

10. In the purchase of swaps, there is always a conflict of interest between the institution and the client for the purposes of MIFID (as of Judgment of the Supreme Court of 22.10.2015).

11. Usually, it is always understood that the financial institution is providing or has undertaken to provide an advisory service, which, in addition to requiring a suitability assessment, raises the level of fiduciary duties owed by the institution (e.g., Judgment of the Supreme Court of 20.4.2017).

12. But, strictly speaking, the control consists in knowing if the individual investor had gained "sufficient" knowledge, regardless of whether the assessment required by MIFID regulation has ultimately been carried out or not. (e.g., Judgment of the Supreme Court of 13.3.2017).

13. In the most recent legal doctrine (compare Judgments of the Supreme Court of 17.2.2014, 15.9.2015 and 15.10.2015), the contractual mistake is not validated by the termination of the swap in order to prevent further losses (Judgments of the Supreme Court of 1.2.2016 and 19.7.2016), the existence of prior negative-value settlements, the existence of prior positive-value settlements for the client, or successive different swaps (e.g., Judgments of the Supreme Court of 17.11.2015, 9.12.2015, 1.2.2016, 25.2.2016 and 20.4.2017: "That the client had a compliant will and paid the relevant negative-value settlements cannot be used against him to consider that such actions had as purpose and effect the confirmation of the vitiated contracts: it is evidence of his contractual good faith, not of his intention to validate a mistakenly given consent"). In addition, only when the purchaser is able to extricate himself from the mistake in which he is in does the time limit of art. 1301 start counting (Judgment of the Supreme Court of 16.12.2015).