



CUTTING EDGE JUDGMENT OF THE ITALIAN SUPREME COURT ON IRS DERIVATIVE CONTRACTS

The recent judgment of the Italian Supreme Court (Corte di Cassazione) (third and final degree of judgment in civil matters) has raised many questions with regard to IRS derivative contracts.

The complex principle expressed by the Court can be summarized as follow: *“the recognition of the possibility for the Public Local Authority [for example a municipality] to conclude derivative contracts, on the basis of the regulations in force until 2013 (when Law 147 of 2013 excluded this possibility) and of the distinction between hedging derivatives and speculative derivatives, based on the criterion of different degree of risk of each of them, meant that only in the first case the Public Local Authority could be considered entitled to proceed with their stipulation. Nevertheless, this stipulation could usefully and effectively take place only in the presence of a precise measurability/determination of the contractual object, including both the mark to market criterion, and the probabilistic scenarios, and the so-called hidden costs, in order to minimize and make the party aware of every aspect of the uncertainty of the relationship, constituting a significant disharmony within the rules relating to public accounting, introducing variables that are not compatible with the certainty of spending commitments reported in the financial statements”.*

At first glance, it is clear that the judgment was issued with reference to a case that concerned derivatives contracts entered into by Public Local Authorities, but, after a closer analysis, some doubts may reasonably arise regarding its possible extension to relationships between private parties, also considering that some first degree judgments and some scholars have already accepted this principle with regard to private transactions.

In particular, what worries most is the fact that the indication of the mark to market and the forecast of the interest rate trend are considered as an essential part of the derivative contract, in the absence of which the contract is void, with consequent obligation to return all the amounts provided by the parties.

These profiles, in addition to not being considered essential or at least a constitutive part of the contract by international practice (in this regard is of particular significance the ISDA contract model and the other determination of this Authority), pose significant practical problems.

The first profile concerns the determination of the mark to market value (i.e. the value of the financial instrument adjusted on the basis of current market prices).

Actually, it is not easy, and in certain cases we believe almost impossible, or in any case too much expensive, to identify the value in the market of a specific derivative

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contract, especially if it involves small parties that operate on a local or regional scale. In fact, in these cases, it is not easy to determine the creditworthiness of the parties.

The second relates to the interest rate forecasts. Indeed, it is certainly difficult to accurately predict the interest rates that may, in many cases, be subject to sudden changes and political interventions (for example interest rates have recently seen an important decrease due to the Covid 19 crisis and of course the pandemic was not a predictable event). But the necessity to indicate a provision of the interest rate forecasts, among the others, presents significant problems also for the responsibility of the subject who has to take charge of the forecasts decision and that has to confirm a certain possible rate for the future. Will this subject, usually a financial institution, ever make this prediction?

In conclusion, on one hand, we believe that the decision of the Italian Supreme Court has a limited scope of application to the disputes that involve Public Local Authorities, emphasizing the necessity of certainty in public spending (despite the fact it is not clear how a derivative contract that allow the Public Local Authority to switch from interest variable rates to fixed rates can increase uncertainty in public spending). On the other hand, it is possible that, in some ways, private parties, that have not concluded a profitable “bet” (this is the term used by the Supreme Court to identify IRS contracts), will try, also thanks to the opinions of certain judges and scholars, to translate the principles expressed by the Italian Supreme Court in private parties transactions. Consequently, nowadays, in Italy, it is reasonable to believe that great attention and special advices are needed in the field of derivatives contracts.

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