

THE VALIDITY OF DERIVATIVE CONTRACTS: COMPARING PERSPECTIVES

With the judgment [2021] EWHC 2706 of 12 October 2021, the Commercial Court (Financial List division) of the High Court of Justice of England and Wales ruled on the validity of the financial derivative contract entered into between the Municipality of Busto Arsizio and Deutsche Bank AG London (the "Busto Arsizio Judgement").

The decision of the High Court of Justice was handed down just over a year after the landmark judgement no. 8770/2020, rendered by the Italian Supreme Court sitting in Joined Chambers, in a case involving leading financial institutions against the Municipality of Cattolica (the so-called "Cattolica Judgment"). The content of the Busto Arsizio Judgement, however, is in sharp contrast with the principles set out by the Italian Supreme Court in the Cattolica Judgment (see our previous Alert on 25 May 2020 [here](#)).

In the context of the Cattolica Judgment, the Italian Supreme Court set out the principles relating to the validity of Interest Rate Swap contracts, stating, in particular, that such contracts:

- should have a 'hedging' nature and not merely 'speculative';
- must include certain information, such as: the mark-to-market value, the probabilistic scenarios and the so-called "hidden costs" of the transaction, stated in a clear manner, known and shared by both parties.

The Italian Supreme Court also declared the invalidity of the contracts at issue, ruling that when derivative agreements include upfront clauses, they must be authorized by a resolution of the Municipality's Council (*Consiglio Comunale*).

The English High Court, on the opposite, while confirming the validity of the derivative contract entered into between the Municipality of Busto Arsizio and Deutsche Bank AG London, ruled that:

- the **hedging** function of a swap should be interpreted in a **broad** and non-restrictive way;
- whether or not the financial intermediary has disclosed to its client the information requested by the Cattolica Judgment (e.g., mark-to-market, probabilistic scenarios and hidden costs) is irrelevant, for the validity of the contract, in those cases where that validity shall be construed and adjudicated on the basis of English law, which in fact does not provide for such disclosure requirement. As opposed to that, what is relevant from a validity standpoint is that the local authority has taken a conscious and informed decision, with an **educated assessment of the risks involved**;
- the approval of the transaction by the Municipality's Council for certain categories of derivative agreements, under English law – being a matter of **authority** and not of capacity – is not required if the acts implemented by the Municipality's Council and the Sector Manager (*Dirigente di Settore*) are thereafter ratified by the Municipality's Council through conclusive actions.

The decision of the High Court of Justice will play a key role for the future litigation – in London and likely abroad – between banks and local authorities, and certainly will not fail to trigger debates in Italy, with a significant impact on the market of derivative financial instruments.

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The Dispute Resolution Department of Legance is available to provide any clarifications, also in respect of any specific situation which may be of interest to you.

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