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Arbitration in swaps: the Portuguese experience

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ABSTRACT

Until very recently the swaps industry seemed to be reluctant to use arbitration or at least was very indifferent as to this mechanism, with disputes almost always being left for the courts of either London or New York to decide. Indeed, these two jurisdictions have been providing a substantial level of quality and speed in resolving disputes. This scenario has been changing over the past few years, and arbitration is now becoming increasingly common in financial and banking transactions, the swaps and derivatives included. Notwithstanding the (small) dimension of the market, the Portuguese case law shows now a considerable and interesting number of cases decided by the courts in swap related matters. In fact, this experience shows that the use of arbitration not only is practicable, but it is also a good option to resolve disputes in the swaps context. Not only are issues of enforcement of the arbitration agreement at stake but, more importantly, intricate questions regarding the notion of "unexpected change in circumstances" (giving rise to the doctrine of "hardship"), the validity of a swap agreement under the doctrines of "gaming or wagering" ("*jeu et pari*") contracts and, lastly, but not less importantly, the (possible) violation of Portuguese public policy. This note addresses the landscape of swap related disputes and the use of arbitration in this context.

'*I know of no reporting mechanism that would come close to describing and measuring the risks in a huge and complex portfolio of derivatives. Auditors can't audit these contracts, and regulators can't regulate them. When I read the pages of "disclosure" in 10-Ks of companies that are entangled with these instruments, all I end up knowing is that I don't know what is going on in their portfolios . . .*'[1]

1. INTRODUCTION

This article addresses the *state-of-the-art* of swap-related disputes, looking at the international landscape in general, with a particular view on the role play that takes place in Portugal on this subject. Our focus will be arbitration as a means of solving

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1 Warren Buffet, 2008 Annual Report (*Berkshire Hathaway, Inc.* 2009), 'Chairman's Letter', 17, <http://www.berkshirehathaway.com/2008ar/2008ar.pdf> accessed 26 January 2016.

disputes in this arena, although we will necessarily pay close attention to experiences in the state courts. In this endeavour, we will attempt to shed some light on whether arbitration is an advisable, or even a necessary, dispute resolution mechanism.

When speaking about swaps in the context of this article, we assume that our readers are familiar with the definition of swaps and other derivative products, and with the particularities of their negotiation. Hence, these matters will not be addressed in detail, but we will look instead at the use of arbitration in this context.

We may, however, offer a few general words on swaps and a possible definition.

2. DEFINING SWAPS AND THE SWAPS MARKET

Since there is no legal definition for a 'swap' contract in the vast majority of jurisdictions (including the Portuguese), we may use the US Commodity Exchange Act, amended by the Dodd–Frank Wall Street Reform and Consumer Protection Act ('Dodd-Frank')[2]:

> [A]ny agreement . . . that provides on an executory basis for the exchange . . . of 1 or more payments based on the value or level of 1 or more . . . rates, currencies, commodities, securities, instruments of indebtedness, indices, quantitative measures, or other financial or economic interests or property of any kind . . . and that transfers, as between the parties to the transaction, in whole or in part, the financial risk associated with a future change in any such value or level without also conveying a current or future direct or indirect ownership interest in an asset (including any enterprise or investment pool) or liability that incorporates the financial risk so transferred.'[3]

It is also important to indicate the relevance of swaps and other derivative products in the context of the international banking and financial market, especially since the figures involved leave no one indifferent. According to the International Swaps and Derivatives Association (ISDA), at the end of 2014 Over-the-Counter (OTC) transactions represented approximately USD 630 trillion of notional outstanding and the Exchange-Traded Derivatives (ETC) amounted to USD 57 trillion of outstanding.[4] Of all OTC transactions at the end of 2014, 80% (approximately USD 505 trillion) were related to 'interest rate contracts' and USD 381 trillion of those consisted of 'interest rate swap agreements' (60% of the global 'OCT' transactions). It is, therefore, indisputable that swaps agreements take on huge proportions, concerning not only notional outstanding amounts but also, and more importantly, the number of transactions. There are millions of transactions occurring each day.[5]

Notwithstanding the relevance of swaps in the context of the banking and financial world, there are (or were until recently) two particular features of this industry

2 Dodd–Frank Wall Street Reform and Consumer Protection Act Pub Law No 11-203, HR 4173 (2010).

3 7 U.S.C. § 1a(47)(A)(iii) 2010.

4 See 'ISDA Derivatives Guide, The Value of Derivatives' <http://www2.isda.org/about-isda/> accessed 29 October 2015.

5 For further developments on the derivatives markets see Rick Grove, 'Overview of Derivative Financial Products', in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford University Press 2015).

which have a direct impact on the applicable legal regulations and on the mechanisms to solve disputes.

3. LEGISLATION AND DISPUTE RESOLUTION MECHANISMS REGARDING SWAPS

The first of these features is that the contents of swaps contracts (and other 'OTC' derivatives) are generally only subject to privately agreed contractual terms and conditions. Virtually every transaction is the result of private bargaining which frames a set of very specific terms (such as amounts, rates, time frames, and the like), and most contractual regulation consists of 'standard form contracts' or 'contracts of adhesion' contained in a 'Master Agreement'. It is worth noting that around 90% of 'OTC' derivative (including swaps) transactions are subject to the 'ISDA Master Agreement' (1992 and 2002 Master Agreements). By contrast, 'ETD' transactions are governed by the respective exchange regulations, with no direct contract entered into between the parties.

The swaps market is generally subject to legal regulation of a banking and financial nature. For instance, in the European context, the Markets in Financial Instruments Directive (MIFID)[6] covers all European-based entities dealing with derivatives. Consequently, countries such as Portugal have adopted legislation implementing that Directive, which means that reference to the notion of 'swap' is now made in the Portuguese Securities Market Code (Articles 2 and 289), and in the General Regime for Credit Institutions and Financial Companies (Article 4), albeit without any definition of the term, as said above. In other jurisdictions, similar legislation has been enacted to enhance consumer protection (for instance, the German Banking Act, amended on 26 June 2012 or the US Dodd–Frank Wall Street Reform and Consumer Protection Act of 21 July 2010). As a result, there is an increase in regulation on transparency requirements and information standards, aimed at ensuring that investors are aware of the true level of actual and potential transactions, and the associated risks, whether they occur on a regulated market, multi-lateral trading facility or others outside these settings.

However, this legislation pertains to what may be considered 'external' aspects of the contractual framework. Indeed, and leaving aside some particular legal provisions related to consumer protection (which we will address below in relation to the Portuguese jurisdiction) which derive from transnational instruments, such as the MIFID regulations, implemented locally, this legislation does not apply to the contents of contracts dealing with swaps but rather to the activity of banks and financial institutions. This legislation may well contain rules of a mandatory nature, the violation of which by banks and other institutions may be grounds for consider the contract as invalid, but it is a legal framework that remains outside the core of the contractual relationship.

The second feature to note is that until very recently the swaps industry seemed to be reluctant to use alternative dispute resolution or at least was very indifferent as to the choice of the dispute resolution mechanism, with disputes almost always being

6 Directive 2004/39/EC amending Council Directives 85/611/EEC and 93/6/EEC and Directive 2000/12/EC of the European Parliament and of the Council and repealing Council Directive 93/22/EEC.

left for the courts of either London or New York to decide. Arbitration was virtually unheard of in the financial industry in general and in the swaps business in particular. This landscape has been changing in recent years, and arbitration is now becoming increasingly common in financial and banking transactions.[7] The swap players are not being left behind.

The limited choice of the New York and London courts for the resolution of disputes arising in the derivative market has been peacefully accepted by the finance and banking industries for the past few decades. These two jurisdictions have provided a substantial level of quality and speed in resolving disputes. English and American court judges are sufficiently (or highly, to be more precise) sophisticated and aware of the issues and questions arising in this context, and the doctrine of precedent provides reasonable comfort to disputing institutions and clients.

However, globalization and the increase in international trade, which have caused the use of new financial products to spread to other jurisdictions, particularly those of developing countries and emerging markets, have recently begun to show that litigation might not be the best available means to solve disputes in this area. In fact, players in those jurisdictions question the need to travel to distant places and have English or American court judges decide their cases. Jury trials and the possible award of punitive damages raise concerns among the banks located in those 'other jurisdictions'. Moreover, court decisions produced in the 'traditional' venues of New York and London do not benefit from a worldwide legal framework for enforcement comparable to that provided by the New York Convention on Recognition and Enforcement of Foreign Arbitral Awards of 1958.

It is true that within the European Union framework, many court decisions may benefit from the legal regime arising from Council Regulation (EC) No. 1215/2012 of 12 December 2012 on jurisdiction and the recognition and enforcement of judgments in civil and commercial matters ('Brussels Regulations'), where they may be enforced relatively easily. Nonetheless, this regime does not apply to enforcement of court decisions outside the European territory.

On another topic, in line with what has been written elsewhere:

> Complex financial transactions agreements place a premium on the knowledge and expertise of those using them. They are, literally and by definition, complex. They are also full of what might be called 'code'-words, expressions and usages, as well as legal underpinnings, known and understood [only] by those who use them. To some extent, the difficulties [in interpreting and understanding the ISDA Master Agreement] also arise from the fact that the ISDA Master Agreement is necessarily a compromise between brevity and the requirement for an agreement that is effective and enforceable under at least two

7 See also Georges Affaki, 'A Banker's Approach to Arbitration', in Gabrielle Kaufmann-Kohler and Viviane Frossard (eds), *Arbitration in Banking and Financial Matters* (ASA Swiss Arbitration Association Special Series No 20, August 2003) 63. See also Inka Hanefeld, 'Arbitration in Banking and Finance' (2013) 9 NYU Journal of Law & Business 918 and Jeffrey Golden and Peter Werner, 'The Modern Role of Arbitration in Banking and Finance', in Jeffrey Golden and Carolyn Lamm (eds), *International Financial Disputes* (Oxford University Press 2015) 1.

governing laws, as well as under other laws that may be chosen as its governing law.[8]

Expertise is, therefore, a crucial requirement for the decision maker.[9]

Hence, arbitration emerges as a better option, and arbitration clauses have been inserted in a range of financial contracts, including derivate transactions covered under the ISDA Master Agreement.

In this respect, one should bear in mind the example of the ISDA Master Agreements (in their versions of 1992 and 2002) because they cover around 90% of all transactions in derivatives, including all kinds of swaps contracts.[10] Not surprisingly, ISDA has been making great efforts not only to extend the use of arbitration mechanisms among its members, but also to include this option in its Master Agreement.

Indeed, during 2011 ISDA issued two memoranda related to the use of arbitration. The first memorandum addressed the general background of arbitration, and also highlighted the concerns related to the use of court litigation in derivatives disputes.

Addressing the 'main reasons for using arbitration for derivatives', the memorandum of January 2011[11] summarized the risks associated with litigating a dispute in judicial courts: '(a) perception of bias or corruption on the part of a judicial authority; (b) delay; (c) lack of experience/expertise by local lawyers and judges in dealing with derivatives contracts; (d) failure by the court to respect a foreign governing law; (e) lack of familiarity with a foreign governing law; (f) lack of consistency in decision-making; (g) having to litigate in an unfamiliar and/or inconvenient language (giving rise to a need to translate documents and evidence).'

In its second memorandum, ISDA acknowledged the enthusiasm that its members manifested regarding the use of arbitration and went further to provide advice in the following matters that had been previously identified: (a) drafting of the arbitration clause; (b) availability of appropriately qualified arbitrators; and (c) developing jurisprudence on interpretation of ISDA documentation.[12] On that same occasion, the 'memorandum' sought the views of ISDA members on those matters, including issues related to the choice of arbitral institutions, availability of a list of specialized arbitrators and drafting of appropriate arbitration clauses.

8 See 'Institute for Banking' of the 'University of Cologne', citing Ross, Capital Markets Law Journal 2012, 221, 256 <http://bankrecht.uni-koeln.de/72/content/150/adr/en>.

9 See Golden and Werner (n 7) 13.

10 According to the International Swaps and Derivatives Association (ISDA), the majority of derivatives users are institutional customers such as corporations, investment managers, governments, municipalities, insurers, energy and commodity firms, funds and international and regional banks, as well as financial institutions—see 'ISDA Derivatives Guide' (n 4).

11 See Peter Werner, 'The Use of Arbitration under an ISDA Master Agreement' http://www2.isda.org/attachment/MjIxNQ==/FLRC_ISDA_Arbitration_Memo_Jan11.pdf>, January 2011 accessed 1 November 2015.

12 The Use of Arbitration under an ISDA Master Agreement: Feedback to Members and policy http://www2.isda.org/attachment/Mzc0NQ==/Arbitration_ISDA_memo_Pt2_Nov11_Final.pdf> November 2011, accessed 1 November 2015.

Subsequently, during 2013 ISDA published its 'Arbitration Guide', containing a range of model clauses, providing for a variety of options at several levels (choice of law, seat of arbitration, institution, and the like), and a very useful handbook addressing the advantages of using arbitration in the derivatives market.[13]

The model clauses are available to be inserted in a Schedule to a Master Agreement and entail the derogation of the default forum jurisdiction clause. As a result, the parties may opt for one of 11 model clauses, producing 18 combinations that take into consideration the seat of arbitration and the rules applicable to the proceedings.

As to the seats, the parties may choose between London, New York, Paris, The Hague, Hong Kong, Singapore, Geneva, and Zurich. Regarding the institutional rules, the choices are: the Swiss Rules of International Arbitration, the Arbitration Rules of the London Court of International Arbitration (LCIA), Rules of Arbitration of the International Chambers of Commerce (ICC), the American Arbitration Association International Dispute Resolution Procedures (IDRC), the Hong Kong International Arbitration Centre (HKIAC) Administered Arbitration Rules, the Arbitration Rules of the Singapore Arbitration Centre (SIAC), and the Arbitration Rules of P.R.I.M.E. Finance.

Conversely, similar master agreements such as the master agreements of the 'London-based Loan Market Association' and of the 'New York-based Loan Syndications and Trading Association' do not provide for the option to include arbitration. Consistently, applicable law and forum jurisdictions clauses point to English law and the London courts, and to US Law and the New York courts, respectively.

In any event, we may follow Zachary Davison's words:

> [P]ublication of the Guide indicates that firms have a strong preference for arbitration in resolving disputes in the derivatives market. Indeed, this is consistent with the desire of firms dealing on the exchange-traded side to implement arbitration clauses as well. The Guide's model arbitration clauses 'reflect the comments of members and interested stakeholders' and represent an increasing use of arbitration in disputes over OTC derivative transactions. This expansion is largely due to the 'ease of enforcing an arbitral award' as opposed to a court judgment in an international setting.[14]

Notwithstanding the great level of enthusiasm shown by businesses dealing in derivatives, which led ISDA to publish its Arbitration Guide, there is no available statistical data on the actual use of arbitration in this industry. There is no objective indication as to this use, and we can only resort to anecdotal evidence, which confirms a growing trend in such use.

13 The Guide <http://www2.isda.org/attachment/NTg0MQ==/ISDA_Arbitration_Guide_Final_09.09.13.pdf> accessed 1 November 2015.

14 Zachary E Davison, 'Minding the Gap: A Call for Standardizing Pre-dispute Arbitration Clauses in OTC Derivative Transactions', (2014–2015) 59 NYL SCH L REV 707.

According to available online sources, typical disputes in swaps contracts include:

> mis-matches between the underlying value of the loan and the interest rate swap, with customers being sold swaps which far exceed the term of their underlying borrowing, or where the notional amount of the swap is far in excess of the actual borrowing (or in some cases both); substantial mis-matches between the length of the loan facility and the length of the swap product coupled with insistence by the bank that the customer enter into the interest rate hedge as a condition precedent of the lending facilities; customers being forced to continue with the interest rate hedges in order to maintain their current lending facility upon renewal; banks failing to explain to their customers the extent of the exit or breakage costs of the swaps and failing to ensure that the derivative products offered meet the needs of the customers; breaches by the banks of their duty of care to customers coupled with negligent (and sometimes even outright fraudulent) misrepresentations by the banks as to the nature or effect of the products sold; and failure by the banks to comply with their regulatory obligations under the FSA Conduct of Business Sourcebook (COBS).[15]

Anecdotal evidence has also shown us that the occurrence of specific events, the calculation of dates, or the interpretation of the master agreements may also be the subject matter of disputes.

Let us now look at the situation in the Portuguese jurisdiction, where the emergence of a comparatively heavy caseload has drawn the attention of many scholars and practitioners.

4. THE PORTUGUESE EXPERIENCE

As we will see below, the Portuguese experience shows that the use of arbitration not only is practicable, but it is also a good option to resolve disputes in the swaps context.

Not only are issues of enforcement of the foreign arbitral award at stake but, more importantly, intricate questions regarding the notion of 'unexpected change in circumstances' (giving rise to the doctrine of 'hardship'), the validity of a swap agreement under the doctrines of 'gaming or wagering' ('jeu et pari') contracts and, lastly, but not less importantly, the (possible) violation of Portuguese public policy. All these matters have to be properly dealt with by the decision maker. It also goes without saying that the very notions and concepts related to the interpretation and application of the swaps contracts call for a specialized adjudicator. More to the point, the Portuguese Superior Courts have consistently upheld the validity of arbitration clauses inserted in the various 'Master Agreements'. Therefore, arbitration might be not only the advisable road, but also the single legally enforceable contractual mechanism for solving disputes in this context.

Thus, the expertise of the decision maker (that arbitration is in general in a better position to provide) and, on the other hand, the enforcement of the arbitration

15 See Cooke, Young and Keidan, LLP, 'Interest Rate Swap Mis-Selling Claims' <http://www.cyklaw.com/interest-rate-swap-mis-selling-claims> accessed 5 November 2015.

clause inserted in numerous swaps contracts, make arbitration a good solution for solving disputes in this arena.

5. THE PORTUGUESE SWAPS MARKET

Statistics on the use of derivatives in general, and swaps more particularly, are not updated regularly in Portugal. In fact, in this respect the Bank of Portugal issues only a triennial survey of foreign exchange and derivatives, the last of which was published on 21 November 2013[16], and which does not seem to be a streamlined source of information.

In any event, the last triennial survey reported:

> in Portugal, a daily average of USD 0.7 billion was traded in interest rate derivatives in April 2013, slightly below the level observed in 2010. Swaps were also the instrument with the highest relative importance in Portugal (52% of average daily turnover).

The numbers cannot be considered negligible, however we look at them.

Notwithstanding, there are no available records or statistical data as to the actual use of arbitration in derivatives disputes in Portugal. There is anecdotal evidence on experiences of arbitration dealing with matters related to swaps agreements, evidencing that the issues discussed in these cases do not differ from the issues raised in cases brought to litigation before the state courts. This observation is comprehensible: the grounds of these cases are insensible to the kind of the mechanisms for solving disputes.

The decisions of the Portuguese Superior Courts (Courts of Appeal and Supreme Court of Justice) are publicly available for consultation[17] (although the identity of the parties is redacted), and there are already a reasonable number of cases demonstrating how the Portuguese courts have been lending support to the use of arbitration in swap-related disputes.

Indeed, these cases back up the notion that arbitration clauses inserted in swaps contracts, even if by way of reference made to a contract of adhesion ('Master Agreement'), are considered valid and enforceable. The experiences reported in these cases, combined with anecdotal evidence, show us that aggrieved parties have basically relied on three theories when seeking the annulment of swaps contracts.

According to the first legal theory, the parties have contested the validity of swaps contracts asserting that they equate to 'gaming and wagering' ('jeu et pari') contracts, generally considered null under Article 1245 of the Portuguese Civil Code. It is worth noting that on one occasion reported in a judicial case, when the swap contract was successfully challenged under this legal theory, the Portuguese Supreme Court of Justice went a step further and considered that 'swaps are in violation of Portuguese public policy'.

16 See 'Statistics on Portugal compiled for the Triennial Central Bank Survey of Foreign Exchange and Derivatives Market Activity – Turnover in April 2013' <http://www.bportugal.pt/en-US/Estatisticas/PublicacoesEstatisticas/NIE/Lists/LinksLitsItemFolder/Attachments/64/PR%2020131121_BOP.pdf> accessed 2 November 2015.

17 <www.dgsi.pt>

Regarding the second legal theory, the particular circumstances experienced by the Portuguese economy in the global environment related to the dramatic fall in interest rates in the aftermath of the world financial crisis of 2008, led to the assertion that swaps ought to be considered capable of being terminated under the theory of 'unexpected and considerable change in circumstances' (giving rise to the theory of 'hardship') set forth in Art. 437 of the Portuguese Civil Code.

Lastly, the third theory asserts the invalidity of the particular standard form contracts ('Master Agreement') at hand due to a lack of sufficient and appropriate information that ought to be provided to clients by the brokers, banks, and other financial institutions. The consequence of this legal theory is that a standard form contract will be null if the proponent has not provided the client with sufficient information as to the contents of the applicable general contractual framework.

This conclusion is very logical, but the factual premises of it are a conundrum: in most cases, claims collapse for want of a factual basis, and banks are often successful in showing that they have provided the client with information at the required level.

Notwithstanding the persuasiveness of the arguments underlying these legal theories, they were not debated by the superior courts in most of the cases due to the successful challenge of the court's jurisdiction on the grounds of the existence of an enforceable arbitration clause. Considering that arbitration proceedings will presumably arise from them, it is likely that arbitral tribunals will be faced with similar arguments and related claims in the near future.

All these considerations also support the notion that the use of arbitration and annulment of contracts may well be a result of special circumstances related to the economic and financial distress that some economies and some economic agents have experienced during the past few years. In any event, the fact that a relevant number of cases have now been dismissed by the courts on the grounds of the 'Kompetenz – Kompetenz' principle is sufficient reason for us to look at the legal landscape of swaps in the light of that judicial experience.

Therefore, we will look at the issue of 'Kompetenz – Kompetenz' in conjunction with the legal framework applicable to standard form contracts. In this respect, we will also look at the case law related to the annulment of swaps standard form contracts on the grounds of lack of sufficient information. We will then briefly describe the issues of 'unexpected change in circumstances' (giving rise to the theory of 'hardship') and of the contract of 'jeu et pari', the latter combined with the issue of a violation of the Portuguese public policy. However, we first need to analyse the case law.

6. ANALYSIS OF THE PORTUGUESE CASE LAW

We have done research using the database system of the judicial courts in Portugal ('DGSI' website) and other relevant databases available to the Portuguese legal community. The query filters that we used[18] were fairly broad to provide a wide spectrum of cases for analysis, totalling 16 cases since 2011.[19] We also consulted private

18 We used the terms 'mercado de balcão' ('over the counter'), 'Swaps' in English and 'derivados' in Portuguese ('derivatives'), both capturing results as diverse as 'contrato de permuta' ('swap contract'), 'interest-rate swap', 'currency swap', and 'credit default swap', and 'cross currency interest-rate swap'.

19 Subsequently to the submission of this note four more cases were published but none relate to arbitration issues. Notwithstanding, one particular case is relevant to this note, where the Portuguese Supreme Court

sources. Despite talking to over 70 colleagues, academics, arbitrators, and counsel, only five cases came to light.

It should be noted that our research may not reflect the whole picture of swap contracts disputes brought before the judicial courts. The Portuguese superior courts generally upload their decisions onto the 'DGSI' website, but some may not be uploaded since they are considered not to be relevant (according to random and subjective criteria). Furthermore, the available databases do not contain decisions of the courts of First Instance, which means that some cases might have been brought to litigation, but were either dismissed or decided without further appeal. Lastly, due to the confidential nature of information collected in relation to arbitral awards, we have to consider information on arbitration as mere anecdotal evidence. Taking in consideration these caveats, we may make the following observations.

All the court decisions were related to lawsuits brought from 2011 onwards. Save for one particular case, all of the sixteen decisions related to a 'business to business' environment. Out of those 16 cases, nine were related to the validity of the arbitration clause inserted in the standard form contract. In eight of those nine cases, the superior courts (six decisions were delivered by the Courts of Appeal and three by the Portuguese Supreme Court of Justice) upheld the validity of the clause. The exception to those decisions[20] relates to a very unexpected interpretation and application of the negative effects of the arbitration clause, making it clear that the Court of Appeal took a view of the principle of 'Kompetenz – Kompetenz' with which we cannot agree. Further, the only decision made in a 'business to consumer' environment relates to the issue of the enforcement of an arbitration clause inserted in a Master Agreement.

Of those 16 cases, one relates to the procedural question of ascertaining whether a swap contract was a sufficient documentary title to enforce, and if a prior declaratory procedure was necessary to determine the quantum of the obligation to enforce. The Coimbra Court of Appeal decided that a quantum declaratory procedure was indeed necessary before the enforcement could take place.[21]

In the other six decisions, the Superior Courts (three decisions of the Courts of Appeal and three of the Portuguese Supreme Court of Justice) addressed issues related to the substance of the swaps contracts.

Out of these six decisions, three concerned the issue of whether a swap contract amounts to a 'gaming and wagering' contract, thus contaminated by nullity under Article 1245 of the Portuguese Civil Code (one decision of the Lisbon Court of Appeal, one decision of the Porto Court of Appeal, and one decision of the Portuguese SCJ[22]). While the Lisbon Court of Appeal annulled the swap contract considering it to be a 'gaming and wagering' contract,[23] the Porto Court of Appeal and the Supreme Court of Justice decided in the opposite direction.[24]

of Justice concluded that a drop in the interest rate however dramatic might have been is not considered as "hardship" (decision of the Portuguese STJ of 26 January 2016, available at <www.dgsi.pt> accessed 28 February 2016).

20 Decision of the Guimarães Court of Appeal of 8 March 2012.

21 Decision of the Coimbra Court of Appeal of 15 October 2013.

22 None of the decisions were related to the same case.

23 Decision of the Lisbon Court of Appeal of 21 March 2013.

24 Decisions of the Porto Court of Appeal of 28 October 2015 and of the Portuguese Supreme Court of Justice of 11 February 2015.

Another two of these six decisions were related to the issue of whether the dramatic fall in the Euribor rates following the 2008 financial crisis amounted to a 'hardship' condition entailing the option granted to the aggrieved party to terminate the contract under the theory of 'unexpected and unfair change in the circumstances'/ 'hardship' (Article 437 of the Portuguese Civil Code). Both the Guimarães Court of Appeal and the Supreme Court of Justice, in two unrelated cases, agreed with this premise, thus annulling the swaps contracts.[25]

Lastly, on one singular occasion the Portuguese Supreme Court of Justice considered the swap contract at hand to be in violation of Portuguese public policy.[26]

Although this report looks at 16 decisions, some of these concerned the same case: the Guimarães Court of Appeal decided the same case on a first occasion in relation to the issue of the enforceability of the arbitration clause[27] and subsequently in relation to the issue of annulment of a swap contract under the 'hardship' grounds. This decision was subject to review by the Portuguese Supreme Court of Justice.[28] Therefore, we found a total of 14 cases which were brought to the Superior Courts in Portugal.

From these decisions, we can reach the following conclusions as to the trends[29] existing among the Portuguese Superior Courts.

The Portuguese Supreme Court of Justice assumed that a swap contract may be considered to be in violation of Portuguese public policy. It further considered that a swap contract may be terminated under the 'hardship' conditions (following a previous decision of the Guimarães Court of Appeal), but is not to be equated to a 'gaming and wagering' contract (thus contradicting a previous decision of the Lisbon Court of Appeal in an unrelated case). Lastly and most importantly, the Supreme Court consistently considered (in three consecutive decisions in three unrelated cases) that an arbitration clause contained in a swap 'standard form contract' ('contract of adhesion') is valid and therefore enforceable. This understanding is shared by the Courts of Appeal of Lisbon, Porto, and Guimarães (the latter had decided to the contrary in a decision made in 2012 but subsequently changed its position, in an unrelated case decided in 2014).

In relation to the arbitration experience, the sources are scarce and scattered. Among the members of the Portuguese arbitration community only a few practitioners (acting either as counsel or arbitrators) and academics were able to report cases in which they were involved. More than 70 people were questioned as to their experience but only five cases were reported.[30]

25 Decisions of the Guimarães Court of Appeal of 31 January 2013 and of the Portuguese Supreme Court of Justice of 10 October 2013. Conversely, a very recent decision of the Portuguese Supreme Court of Justice of 26 January 2016 concluded that a drastic drop in the interest rate does not amount to "hardship" and therefore upheld the validity of the contract at stake.

26 Decision of the Portuguese Supreme Court of Justice of 29 January 2015.

27 Decision of the Guimarães Court of Appeal of 3 August 2012.

28 Decision of the Guimarães Court of Appeal of 31 January 2013 and decision of the Portuguese Supreme Court of Justice of 10 October 2013. One should note here the speed of the Superior Courts, which produced three decisions on the same case in a 14-month period.

29 It is worth noting that in Portugal the 'stare decisis' principle does not apply save for exceptional circumstances, which have not yet occured in any swap-related case.

30 One 'extra' case was reported to us from Brazil.

In any case, the issues at hand were very similar to those brought before the state courts: termination and annulment of the contract under the 'hardship' conditions, nullity of the contract due to being classified as a 'gaming and wagering' contract, lack of information within the contract of adhesion legal framework, and mistake. In each case, these grounds were combined with contractual liability of the broker, bank, or financial institution.

The scarcity of the cases does not justify further analysis. However, it is interesting to note that the grounds upon which the claims were based do not differ from the judicial cases.

Conversely, it seems that the spectrum of cases arising from the Portuguese experience in swap-related disputes (both in litigation and arbitration) reveals a somewhat different scenario to that which has been described above in relation to the international landscape. The Portuguese experience has indeed to report other issues of law, which we will look at below, but first let us say a few words on the topic of arbitrability and jurisdictional issues related to disputes concerning swaps.

Our aim here is not to provide an in-depth discussion on the questions and legal debate connected to the disputes that have arisen in the context of swaps contracts, but only to give a bird's eye view of the Portuguese jurisdiction.[31]

7. ARBITRABILITY AND JURISDICTIONAL ISSUES

One question that may arise is whether disputes involving swaps contracts are arbitrable or not, especially taking into account the fact that a recent decision of the Portuguese Supreme Court of Justice considered a swap contract to be in violation of Portuguese public policy. On the other hand, the existence of regulation which is external to the contract may lead us to question whether or not mandatory rules are at stake and, therefore, whether arbitral tribunals have jurisdiction to decide the dispute. These topics have been the subject of great debate and the scope of this article does not allow us to resume it. In any event, we may provide a brief background of

31 As a matter of legal discussion among scholars and practitioners, relevant to the issues that will be discussed below, see Paulo Mota Pinto, in 'Contrato de swap de taxas de juro, jogo e aposta e alteração das circunstâncias que fundaram a decisão de contratar', Revista de Legislação e Jurisprudência, nos 3987 and 3988, 2014 and João Calvão da Silva, 'Swap de taxa de juro: inaplicabilidade do regime da alteração das circunstâncias', in Revista de Legislação e Jurisprudência, , no 3986, 2014 and 'Swap de taxa de juro: a sua legalidade e autonomia e inaplicabilidade da excepção do jogo e aposta', in R.L.J, no 3979, May–April, 2013. See also relevant bibliography: António Pereira de Almeida, 'Instrumentos financeiros: os swaps', in 'Estudos de Homenagem ao Professor Doutor Carlos Ferreira de Almeida', 2011, II; António M. Vitorino, 'Estudo sobre permuta de divisas e de taxas de juro ("swaps")', in 'Revista da Banca', 40, October–December 1996; Carlos Ferreira de Almeida, 'Contratos diferenciais', apud 'II – Estudos Comemorativos dos 10 anos da Faculdade de Direito da Universidade Nova de Lisboa', 81, 110; João Cantiga Esteves, 'Contratos de swap revisitados', in Cadernos do Mercado dos Valores Mobiliários, 44, April 2013; José Engrácia Antunes, 'Os derivados', in Cadernos do Mercado dos Valores Mobiliários, Instrumentos Financeiros, 2003; Maria Clara Calheiros, 'O contrato de swap no contexto da actual crise financeira global', in Cadernos de Direito Privado, 42, 2013; Maria Clara Calheiros, 'O Contrato de Swap', in 'Studia Iurídica', 2000; António Menezes Cordeiro, Manual de Direito Bancário; José de Oliveira Ascensão, 'Derivados', in Revista do Direito dos Valores Mobiliários, IV, 2003; Pedro Boullosa Gonzales, 'Interest Rate Swaps: Perspectiva Jurídica', in Cadernos do Mercado de Valores Mobiliários no 4, April 2013; Rui Pinto Duarte 'O Jogo e o Direito', in Themis, 3. See also, Alistair Hudson, 'Swaps and Wagering Contracts' (1995–1996) in The Kings College Law Journal, 6,; David Megle, 'Economic Role of Speculation', in ISDA, Research Notes 2, 2010.

how these issues are dealt with in the Portuguese jurisdiction, although we must say from the outset that, since many years now, we consider the jurisdiction and/or arbitrabilitiy issues to differ in nature from issues related to the kind of claim or to the rules applicable to the merits of the dispute.[32]

First, within the circle of the legal relationships between the client and the financial institution, all the disputes that have arisen (and possibly may arise in the future) relate to issues of a private nature. Further, they relate to purely economic interests.

According to the new Portuguese Arbitration Law 'any dispute involving economic interests may be referred by the parties to arbitration, by means of an arbitration agreement, provided that it is not exclusively submitted by a special law to the State courts or to compulsory arbitration' (Article 1(1) 'PAL'). Following the Austrian, German and Swiss (Private International) Laws, the Portuguese Arbitration Law now follows a 'patrimonial' criterion as a filter of arbitrability.[33]

Secondly, the Portuguese law does not set forth a 'public policy' threshold similar to the one provided for in the French domestic arbitration framework (Article 2060 of the French Civil Code), which means that even if a swap contract entailed a violation of Portuguese public policy, this would not be a deterrent for the arbitrability of the dispute.

Thirdly, as we have seen above, swaps are subject to some 'external' regulation (including regulation implementing the MIFID Directive with the effect of enhancing transparency and information duties), which may be considered as mandatory and, on the other hand, the question has been raised as to whether swap contracts are contrary to Portuguese public policy if they are not attached to a real and actual economic or financial transaction, which means they are purely 'speculative' and equates them to a 'gaming and wagering' contract, thus making them null and void. As a consequence, the jurisdiction of an arbitral tribunal to decide such disputes may be challenged if one does not accept the full application of the principle of the autonomy of the agreement to arbitrate.

In this respect, the Portuguese jurisdiction has already followed the way paved by the *US Mitsubishi v Soler* case[34], and now expressly admits that arbitral tribunals may apply mandatory rules without want of jurisdiction to do so. Indeed, in a decision of 16 February 2005, the Guimarães Court of Appeal considered that a dispute related to a 'goodwill compensation' of the commercial agent could be decided by arbitration notwithstanding the fact that such right stems from a mandatory legal provision.[35] Furthermore, even if these rules of a mandatory nature equate to '*lois de police*' or to Portuguese public policy, which is not necessarily accurate (but we will not entertain such discussion here), it remains for the arbitral tribunal to apply or deny application of such rules without violation of its competence to hear the case.

In other words, arbitral tribunals may apply mandatory rules, whether those rules assume the nature of rules of 'public policy' or not. Whether the arbitral awards may

32 See Paula Costa e Silva, 'A nova face da justiça – Os meios extrajudiciais de resolução de controvérsias' (2009) Coimbra Editora, 85ff.

33 In relation to disputes not involving economic interests, 'the arbitration agreement is also valid provided that the parties are entitled to conclude a settlement on the right in dispute' (art 1(2) of the PAL).

34 *Mitsubishi Motors Corp. v Soler Chrysler-Plym- outh, Inc.* (1985) 473 US 614, 631.

35 Decision <www.dgs.pt> accessed 6 November 2015.

be set aside for violation of public policy is a different matter, which is not going to be debated here.

In sum, we do not see any kind of constraints as to the arbitrability of swap-related disputes, and as to the jurisdiction of the arbitral tribunal to decide such cases.

8. 'KOMPETENZ – KOMPETENZ' AND THE NEGATIVE EFFECTS OF THE ARBITRATION AGREEMENT

The twin principles of 'Kompetenz – Kompetenz' and the negative effects of an arbitration agreement have been discussed so many times on grounds of theory that we need not elaborate further in this respect. However, it is worth noting that the Portuguese legal setting (in terms of the case law, the legal provisions, and the doctrinal works) is largely adapted to the international standards applicable in this regard, particularly to the New York Convention of 1958.

Indeed, Article 18(1) of the Portuguese Arbitration Law[36] states that:

> The arbitral tribunal may rule on its own jurisdiction, even if for that purpose it is necessary to assess the existence, the validity or the effectiveness of the arbitration agreement or of the contract of which it forms part, or the applicability of the said arbitration agreement.

Thus, an arbitration agreement produces a negative effect as to the jurisdiction of a judicial court when seized with a dispute covered by such agreement:

> The State court before which an action is brought in a matter which is the object of an arbitration agreement shall, if the respondent so requests not later than when submitting its first statement on the substance of the dispute, dismiss the case, unless it finds that the arbitration agreement is clearly null and void, is or became inoperative or is incapable of being performed (Art. 5(1) 'PAL').

We do not need to search outside the realm of swaps contracts to find case law affirming the idea above. In fact, the Portuguese Supreme Court of Justice decided that:

> Unless the court finds that the arbitration agreement is manifestly invalid or unenforceable, the plausible existence of a commitment of the parties to such kind of agreement is sufficient for the court to refer to the arbitral tribunal the issue concerning its own competence without further ado.[37]

However, and quite surprisingly, in a swap-related case, the Guimarães Court of Appeal once decided that if the petitioner had raised the question of the validity of the contract containing the arbitration agreement on the grounds of a relevant and

36 The Portuguese Arbitration Law (PAL) was enacted by Law No 63/2011 of 14 December 2011. All legal provisions herein cited are reproduced from the English translation available at the 'Portuguese Arbitration Association' (APA) website <www.arbitragem.pt>.

37 Decision of 9 July 2015 <www.dgsi.pt>.

operative cause of mistake, or if the petitioner calls for the termination of that contract on the grounds of a relevant and operative cause of hardship, and considering at the same time that no banking or financial issues are involved in these propositions, the judicial court will not lack jurisdiction to hear the claim.[38]

In other words, the Guimarães Court of Appeal applied the following rationale: if the validity of the contract containing an arbitration clause is disputed, then the arbitral tribunal will lack competence to decide the case.

This reasoning clearly defies the very pillars of the arbitration 'acquis', forgetting the intellectual and legal acquisitions of the 'separability' principle, so well-grounded for many decades now in virtually every jurisdiction in the world, the Portuguese being no exception. Fortunately, the very same Court of Appeal later changed its position in a swap-related case and reverted to the understanding aligned with the legal provisions.[39]

It is also worth noting that this understanding does not change in consideration of the fact that the arbitration clause is inserted in a swap contract that is classified as a 'standard form contract' ('contract of adhesion').

Indeed, in the context of disputes related to swap contracts, each and every decision of the Superior Courts addressing the competence of the arbitral tribunal (or, rather, addressing the lack of competence of the judicial courts to hear those disputes), also addressed the issue of whether swaps contracts should be classified as 'contracts of adhesion'. If that were the case, and according to the contentions of the petitioners, two-fold issues would arise: on the one hand, it would be necessary to know whether an arbitration clause inserted in a 'contract of adhesion' could stand 'de per se'; if that were not the case, on the other hand, then the arbitration clause should be disregarded for lack of sufficient and appropriate information that should have been provided by the broker or bank institution in the context of the bargaining process of the whole contract.

The contractual documentation covering swaps is in fact a standard form contract or a mere contract of adhesion. Broadly speaking and taking its usual layout, this framework of documents is aimed at documenting the derivatives operations, consisting of a master agreement, a schedule (containing the particular terms and conditions of each operation), confirmations, definition materials or booklets, and a credit support annex. The 'master agreement' sets forth fixed terms that apply to all future transactions between the parties. Therefore, each time a new transaction is entered into between the parties, those general terms need not be re-negotiated. Thus, with the exception of the particular terms contained in the applicable schedules, all the remainder of the contractual framework is pre-negotiated and fixed.

It is true that even those general terms and conditions may be subject to bargaining. They are private contracts after all, and their contents are not established by any legal regulation. Yet, the imbalance between the powers of the proponent (usually a bank, or a broker, frequently dealing with laypersons) and of the client on the one hand, and the refined technical detail and comprehension of those terms, on the other, usually lead to situations where the client does not read or does not have

38 Decision of the Guimarães Court of Appeal of 8 March 2012.

39 Decision of the Guimarães Court of Appeal of 25 September 2014.

sufficient ability to understand those terms and conditions. As a result, the vast majority of these terms and conditions, including the arbitration clause inserted in the master agreement, are not subject to effective negotiation. For illustrative purposes, in one of the cases decided by the Portuguese Supreme Court of Justice, the client (petitioner) had been granted only 24 hours to read and analyse the contract bundle that was sent to him.[40] It is simply unrealistic to assume that this contract had been negotiated.

The legal regime applicable to contracts of adhesion is indeed very much concerned with consumer protection. The legal framework does not differ much from the 'acquis communautaire' (especially the regulation issued in the context of the MIFID directive).

In fact, the Portuguese legal regime applicable to standard form contracts is set forth in Decree-Law No. 446/85, of 25 October 1985 ('DL 446/85'), with the amendments made to it in 1995, 1999, and 2001.[41] Pursuant to DL 446/85, a standard form contract is defined as 'general contractual clauses drafted without prior individual negotiations, which indeterminate tenderers or recipients are limited to subscribing to or accepting, respectively' (Article 1(1) of 'DL 446/85'). As a consequence, if a particular contract has been subject to a negotiation between the parties as regards its terms and conditions, it will no longer be considered as a standard form contract or contract of adhesion.[42]

We need to take into account that a swap contract is generally governed by two kinds of contracts: a particular set of documents that is negotiated (namely, the schedule containing the particular terms of the contract), and another part (the 'Master Agreement') which is pre-determined and contains fixed non-negotiable terms. The fact that the schedule is subject to negotiation does not clash with the conclusion that the remainder of the contract (the 'Master Agreement') will still be considered a standard form contract.

Conversely, if the 'Master Agreement' has been subject to negotiations, irrespective of the degree of discussion that has taken place, we will no longer have a contract of adhesion but rather a regular private contract that falls outside the scope of the legal regime applicable to standard form contracts.

According to DL 446/85, for general contractual clauses to be valid and enforceable, the businesses which use such clauses are bound to notify clients of: (i) the content of the general clauses; and (ii) the meaning of such clauses that may need clarification (Articles 5 and 6 of 'DL 446/85').

40 Decision of the Portuguese Supreme Court of Justice of 28 May 2015.

41 Decree-Law No 220/95 of 31 August 1995, Decree-Law No 249/99 of 7 July 1999 and Decree-Law No 323/2001 of 17 December 2001.

42 Nonetheless, outside the context of swaps disputes, in a decision of 19 June 2013, the Coimbra Court of Appeal found that the arbitration clause was invalid under Portuguese law because it was a standard clause that had not been negotiated between the parties. The particularity of this case is that the factual background showed that a substantial part of the contract but the arbitration clause had been subject to effective negotiations (the other party had produced amendments and deletions to the template). In other words, the understanding of the Coimbra Court of Appeal was that a contractual stipulation not subject to bargaining between the parties is to be classified as 'standard clause' and therefore null—see Albert Jan Van Den Berg (ed.), *Yearbook Commercial Arbitration* (Kluwer Law International, The Hague 2014) XXXIX 470.

More importantly, DL 446/85 provides several grounds when a given clause (including arbitration clauses) will be considered null and void. These grounds are classified as: (i) common grounds which are applicable in both 'business-to-business' and 'business-to-consumer' environments; (ii) a specific ground contemplated for clauses within a 'business-to-consumer' environment; and (iii) a specific ground contemplated in relation to a 'business-to-business' setting.

(i) First, DL 446/85 stipulates that standard form contracts will be null and void (leaving aside any formality requirements set by DL 446/85 such as those set forth in Article 8) when their essential terms appear to be uncertain or when the imbalance in benefits seriously offends good-faith (Article 9(2) of 'DL 446/85'). Secondly, DL 446/85 contains a general provision stating that general contractual clauses in violation of good faith are null and void (Article 15 of 'DL 446/85').

These two provisions are the 'common grounds' as stated above. It is worth noting that there is somehow a confusing overlap between those provisions as both address clauses that constitute a violation of 'good faith'. However, this is not the place to consider this issue further, and, moreover, clarifying this confusion is not particularly relevant for our purposes here.

(ii) Regarding 'business-to-consumer' relationships, there is an absolute prohibition on clauses that 'exclude or restrict in advance the possibility of requiring judicial protection for litigious situations which arise between the parties or that provide for arbitration procedures that do not provide the guarantees of procedure laid down in law' (Article 21(h)) of DL 446/85', as amended by Decree-Law No. 220/95 of 31 August 1995. Furthermore, it is worth noting that the Portuguese Securities Market Code (Article 321[3]) classifies the legal relationship between a retail investor and a financial institution as a consumer relationship.

In this regard, a question arises as to whether the provisions of Article 21(h) are set forth in the alternative, ie a general standard clause will be deemed to be null and void whenever (a) it sets out that the parties are compelled to resort to arbitration (and are therefore prevented from recourse to state courts) or (b) if that clause sets forth an arbitral procedure that does not comply with the procedure guarantees laid down in law. In other words, the question is whether this legal provision prevents the parties from agreeing to an arbitration clause as an *exclusive* recourse to settle the disputes arising from a standard form contract or not.

Notably, in its decision of 3 March 2005, the Portuguese Supreme Court of Justice held that an arbitration clause, inserted in a standard form contract, providing that 'all interpretations and integrations of omissions and resolution of conflicts arising out of this contract, shall be the exclusive jurisdiction of an arbitral tribunal, to be constituted in accordance with Chapter II, of Law 31/86, of 29 August' was not in violation of Article 21, al. (h) of 'DL 446/85', and therefore was not null or void.[43]

43 The case concerned a brokerage agreement between a financial institution and a consumer for the subscription, sale and transaction of securities in a regulated marketplace. Claiming a breach of that agreement, the consumer brought an action in a Portuguese state court to seek a remedy for its losses. The financial institution contested the jurisdiction of the state court, claiming that the arbitration clause was valid and enforceable and, therefore, the state court should dismiss the claim and refer the parties to arbitration. The consumer responded that general contractual clauses may foresee arbitration as a dispute

The Supreme Court of Justice upheld the previous decisions that considered such agreement to be a standard form contract, thus subject to the legal provisions of 'DL 446/85'. In its decision, the court relied on the provision of Article 21, al. (h) and held that the jurisdiction of an arbitral tribunal may be exclusive or concurrent with the jurisdiction of a state court, which is why the clause at hand would not be invalid. The Supreme Court of Justice concluded by stating that 'the clause could only be construed as absolutely prohibited if the procedural guarantees provided by law were not provided for [the arbitration proceedings]'.[44]

In the specific context of swap-related disputes, the Portuguese Supreme Court decided that an arbitration clause inserted in a contract of adhesion, although such contract relates to a 'business-to-consumer' setting, is to be valid and enforced.[45]

Within this setting, the issue seems to be well settled now.

(iii) With regard to the 'business-to-business environment', the legal provision applies to forum selection clauses that 'involve serious disadvantages (i.e. "gross inconvenience") for one of the parties and the interests of the other do not justify that selection' (Article 19(g) of 'DL 446/85'). To assert the invalidity of an arbitration clause on this ground in a presumptive way, one would have to assert that the arbitration procedure would carry 'serious disadvantages' in any circumstances.

However, whether or not arbitration carries serious disadvantages is an issue that will depend on the circumstances of each case. For example, a forum clause that requires a party living in the southernmost point of Portugal to litigate in a state court in the northern part of Europe might be considered null and void under the provision of Article 19(g) of DL 446/85 because it might cause 'gross inconvenience' to the Portuguese party. Although a subjective analysis of the circumstances of each case may be relied upon, and even be considered a matter of legal 'good sense and sensibility', this provision is fairly clear and understandable.

Besides that, to rebut the argument that the arbitration procedure carries serious disadvantages, one could list the advantages of arbitration, as others have done:

> [a]mong the reasons parties may agree to arbitration (or may include arbitration clauses in their standard form contracts) are the following: (1) arbitration may resolve disputes more quickly and at lower cost than litigation; (2) arbitration may reduce the risk of aberrational jury verdicts or punitive damages awards; (3) arbitration may reduce company's exposure to class actions or other forms of aggregate litigation; (4) arbitration may result in better outcomes because the decision makers are experts whose incentives differ from

resolution mechanism but could not set forth the exclusive jurisdiction of the arbitral tribunal at risk of such clause being invalid for limiting or excluding the possibility of judicial review.

44 Decision of the Portuguese Supreme Court of Justice of 3 March 2005 <http://www.dgsi.pt/jstj.nsf/954f0ce6ad9dd8b980256b5f003fa814/dc750c1cf5660e4f802570a70030122c?> OpenDocument, accessed 5 November 2015. For a contrary understanding, opining that this legal provision seems to indicate that an exclusive arbitral jurisdiction clause will be absolutely prohibited and only clauses that set forth concurrent jurisdictions of arbitral tribunals and state courts are not deemed to be invalid, see Professor Dário Moura Vicente, Portuguese edition of 'A manifestação do consentimento na convenção de arbitragem', in *Revista da Faculdade de Direito da Universidade de Lisboa* vol. XLIII, no 2 (Coimbra Editora 2002) 998.

45 See decision of the Portuguese Supreme Court of Justice of 28 May 2015.

> those of judges; (5) arbitration may reduce the risk of disclosure of confidential information; (6) arbitration may facilitate the use of privately developed trade rules; (7) arbitration may better preserve the parties' relationship.[46]

While some of the advantages cited above do not apply to Portugal (such as jury verdicts or punitive damages), other advantages remain accurate in the context of the rights of Portuguese consumers. Therefore, we can neither conclude that arbitration clauses carry 'serious disadvantages' nor assert that they represent an 'imbalance in the benefits [that] seriously offends good-faith'.

In any event, none of the decisions of the Portuguese Superior Courts related to cases where this imbalance was either invoked or established.

9. LACK OF CLARITY AND INFORMATION RELATED TO THE SWAPS MASTER AGREEMENT

The anecdotal evidence related to arbitration cases (as well as the few cases brought before the judicial courts) that we were able to collect shows us that the claimants (and petitioners) contested the validity and enforceability of the swap contract on the grounds of lack of clarity, and claiming that the brokers, banks, and financial institutions that 'sold' those products failed to provide sufficient and appropriate information as to the terms and conditions of the contractual framework. Further, some pressed the point that the obligations of transparency and information deriving from local regulation that implements the MIFID directive were not complied with, thus giving grounds to annul the contract. This argument was made as a last resort for their claims: indeed, anticipating a possible failure on the other substantive challenges (violation of the public policy and nullity of the 'gaming and wagering' equated contract, and hardship), the aggrieved clients relied upon the fact that swaps contracts are 'contracts of adhesion' and that the institution selling those products failed to explain and provide information as to the contents of the terms and conditions of those contracts.

As said above, Decree-Law No. 446/85 sets forth that the businesses who use general contractual clauses are bound to communicate to their clients: (i) the contents of the general clauses and (ii) the meaning of such clauses that may need clarification (Articles 5 and 6 of 'DL 446/85'). These obligations are underscored by local regulation enacting the principles of the MIFID directive. The penalty for non-compliance with these obligations is the nullity of the contract, and therefore restitution to the client of every sum he or she may have disbursed to the bank.

One may easily imagine that this challenge relies substantially on the factual background that must be established in the proceedings. Although almost every aggrieved client showed a lack of a sufficient level of knowledge, let alone sophistication, to properly understand and comprehend a swap contract, the reality is that the establishment of those facts is not a hard task to accomplish. Banks and other financial institutions may enjoy here a safe journey on account of a factual background which is

46 Christopher R Drahozal and Quentin R Wittrock, 'Is there a Flight From Arbitration?' (2008) 37(1) Hofstra Law Review 71. See also Stephen J Ware, 'Paying the Price of Process: Judicial Regulation of Consumer Arbitration Agreements' (2001) 2001 Journal of Dispute Resolution 89, 101.

easy for them to demonstrate (and this is not their fault). We may well admit that, considering the nature of swaps contracts (contracts of adhesion), the burden of proof should shift to the party that holds the duty and therefore the risk of providing comprehensive and accurate information to the counterparty—and the party carrying that risk is obviously the bank or the broker acting on its behalf. However, and again, the standards of proof are met with relatively ease by banks.

This was precisely the result of the procedures brought before the courts in the case decided by the Portuguese Supreme Court of Justice on 28 May 2015, where it was considered that the mere allegation that a swap is a 'standard form contract' would not suffice to produce its nullity, it being necessary instead to contend and establish that that contract was not subject to real negotiations and that the bank had failed to provide sufficient and accurate information.

In any case, if those aggrieved clients had met the requirements of the burden of proof, they would certainly have achieved an outcome similar to some cases decided in other jurisdictions, such as Germany, where the *Bundesgerichtshof*, in a decision of 22 March 2011 (XI ZR 33/10), considered that the broker had not complied with its duties to ascertain whether its client had the real propensity to bear the financial risk involved in the complex product (*in casu*, a *Constant Maturity Spread Ladder Swap*) thus awarding damages to the broker's client.

10. GAMING AND WAGERING, AND PUBLIC POLICY ISSUES

It has been argued before the courts and arbitral tribunals that swaps contracts cannot be equated to real and concrete financial or economic transactions. They are, therefore, considered to be instruments producing an 'abstract' legal relationship of a mere speculative nature. In some circumstances, like the ones described in the factual background of those cases, this speculation is not tolerated by the legal system because it is in want of a reasonable and acceptable social–economic justification or consideration ('cause'), which contradicts the very purposes of the rights in question. Therefore, the argument goes, since swap contracts lack that social and economic acceptance, they also violate Portuguese public policy, thus being null and void under Article 280 of the Portuguese Civil Code.[47] Furthermore, this lack of social and economic justification turns those contracts into 'gaming and wagering' contracts, which are also considered null and incapable of producing legally enforceable obligations (Article 1245 of the same Code).

Regarding the issue of whether or not a swap contract equates to a 'gaming and wagering' contract, the Portuguese Superior Courts took different views on two separate occasions.

On the first occasion[48], the Lisbon Court of Appeal considered that a derivative contract, as the swap contract at hand intended to be, must refer to a real notional submitted to financial variations. Hence, one must look at the actual purposes that

47 See, supporting this understanding, José Lebre de Freitas, 'Contrato de swap Meramente Especulativo - Regimes de validade e de alteração de circunstâncias' <www.oa.pt/upl/%7B24d07a7e-a1e3-4f43-b06a-300e112c9896%7D.pdf>

48 Decision of the Lisbon Court of Appeal of 21 March 2013.

the contract aimed to achieve, such as obtaining proper control or hedging of the financial risks of the client, and at the reality underlying it, such as the client's debt levels and costs. The derivative character of a swap contract is based on hedging of a particular risk, such as the risk related to the interest rates fluctuation of a particular financial or economic transaction. Once this 'derivation' ceases to exist, while the swap contract nevertheless remains in force, we no longer have a real derivative (swap) contract, but rather a wagering contract. Thus, according to the Lisbon Court of Appeal, the swap contract is null under the legal regime outlined in Article 1245 of the Portuguese Civil Code.

On a subsequent and unrelated occasion, the Portuguese Supreme Court of Justice[49] construed swaps contracts differently, considering that parties may make use of such contracts even if no real and actual 'notional' is involved. For a contract to be valid and enforceable there is no need for a real attachment with another financial or economic transaction to exist.[50] Therefore, a contract of an 'abstract' nature is admissible. Furthermore, it is not necessary for the contract to aim at hedging any financial risk. Hence, the swap contract does not equate to a 'gaming and wagering' contract.

This understanding was reaffirmed later by the Porto Court of Appeal[51], which not only considered a contract with no actual pertinence to a real financial or economic transaction to be admissible, but also admitted the validity of a contract of a mere speculative character.

Closely related to this topic is the issue raised in a subsequent (and unrelated) decision of the Portuguese Supreme Court of Justice.[52] In this case, the Supreme Court addressed the question of whether the swap contract had a merely speculative character only and, if so, whether it should be considered in violation of Portuguese public policy. Drawing substantially from the same premises of the decision of the Lisbon Court of Appeal noted above, the Supreme Court of Justice reached the conclusion that the lack of a match between the 'speculator' factor of the swap contract and the hedge (coverage of a particular financial risk) led to the conclusion that such contract should be classified as purely speculative.

The Supreme Court went further and asserted that the legal system does not tolerate financial speculation without restriction: some kinds of speculation are healthy for the economy and are morally acceptable, while other kinds of speculation, especially those which do not have any connection with real and actual risks, are substantially hazardous in social and economic terms ('*spéculation hasardeuse*'). In the case at hand, the Supreme Court could not find such a match and therefore considered that the contract had a purely speculative nature, and was not admissible at the social and economic levels. Consequently, the contract was in breach of Portuguese public policy and, therefore, ought to be considered null under Article 280(2) of the Portuguese Civil Code.

49 Decision of the Portuguese Supreme Court of Justice of 11 February 2015.

50 Supporting this view are Paulo Mota Pinto and João Calvão da Silva cited (n 31).

51 Decision of the Porto Court of Appeal of 28 October 2015.

52 Decision of the Portuguese Supreme Court of Justice of 29 January 2015.

It is interesting to consider what the impact of these considerations might be in light of a set aside proceeding and of an enforcement of a foreign arbitral award. Indeed, violation of Portuguese public policy is grounds to either annul an award (Article 46(3)(b)(ii) of 'PAL'[53]) or refuse recognition of a foreign arbitral award (Article 56(1)(b)(ii) of 'PAL').

To put if differently, what decision should a state court take if it is seized with a setting aside procedure (or a recognition of a foreign arbitral award) where the arbitral tribunal had held to be valid a swap contract that might have been considered in violation of Portuguese public policy on the same grounds as the aforementioned case decided by the Supreme Court of Justice?

It is far beyond the scope of this article to address the issue of public policy.[54] However, we may briefly say that the principles of public policy that may be grounds to both set aside an award and refuse the recognition of a foreign arbitral award are restricted to those of the 'international public policy of the Portuguese state', rather than to the 'domestic' public policy. Moreover, the 'international public policy' is narrower than the domestic public policy.

Regarding the standards that the Portuguese courts have been applying, we may draw from the 'Final ILA Report on Public Policy',[55] whose principles and standards the Portuguese courts have followed in several instances. The Report provides us with a list of situations equating to the various forms of 'public policy', as classified therein. Indeed, the Report indicates the following definition of 'international public policy' (*Recommendation* 1(*c*)):

> the body of principles and rules recognised by a State, which, by their nature, may bar the recognition or enforcement of an arbitral award rendered in the context of international commercial arbitration when recognition or enforcement of said award would entail their violation on account either of the procedure pursuant to which it was rendered (procedural international public policy) or of its contents (substantive international public policy).

If further concludes (*Recommendation 1(d)*) that,

> the international public policy of any State includes: (i) fundamental principles, pertaining to justice or morality, that the State wishes to protect even when it is not directly concerned; (ii) rules designed to serve the essential political, social or economic interests of the State, these being known as *'lois de*

53 Even if it relates to an 'award made in Portugal, in an international arbitration in which non-Portuguese law has been applied to the merits of the dispute . . .'—art 56 'PAL').

54 Regarding the international public policy of the Portuguese state, see Duarte G Henriques, 'I Will Not Go That Way: What The International Public Policy Of The Portuguese State Is Not', in *Mealey's International Arbitration Report, Vol. 30* (Lexis-Nexis, 2 February 2015).

55 'Final ILA Report on Public Policy as a Bar to Enforcement of International Arbitral Awards', presented at the Seventieth Conference of the International Law Association held in New Delhi, April 2002, and first published in the Report of the Conference, by Pierre Mayer (Chairman of the Committee) and Audley Sheppard (Rapporteur of the Committee), in Arbitration International (2003) 19(2): 249–63. <www.ila-hq.org/download.cfm/docid/032880D5-46CE-4CB0-912A0B91832E11AF>.

> *police*' or 'public policy rules'; and (iii) the duty of the State to respect its obligations towards other States or international organisations.

The Report goes further and provides several 'examples' of principles that may be encapsulated by the notion of 'international public policy'. It goes without saying that the situations brought before the Portuguese courts regarding swaps contracts do not fit squarely within in any of those 'examples'.

The Portuguese courts follow these principles and standards and, therefore, we do not believe that there is any room for considering a swap contract to be in violation of the principles of the 'international public policy' of the Portuguese state.

11. HARDSHIP

A final grounds upon which the validity of swaps contracts has been disputed is related to the occurrence of an 'unexpected and unreasonable change in the circumstances' that were considered during the negotiation of the contract.

In this respect, we may draw almost exclusively on one of the most valuable contributions to the development of international comparative law, the 'Trans-Lex' database[56], which provides us with the definition, the requirements and the consequences of a 'hardship' situation.

According to 'Principle No. VIII.1':

> Any event of legal, economic, technical, political or financial nature
> which occurs or becomes known to the disadvantaged party after the conclusion of the contract,
> which could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract and
> which fundamentally alters the equilibrium of the contractual obligations, thereby rendering the performance of the contract excessively onerous for that party provided that party has not, through express stipulation or by the nature of the contract, assumed the risk of that event,
> constitutes hardship ('Wegfall der Geschäftsgrundlage', 'clausula rebus sic stantibus', 'frustration of purpose').

The legal consequences are set forth in 'Principle VIII.2':

> (a) In case of hardship, the aggrieved party may claim renegotiation of the contract with a view to reach agreement on alternative contractual terms which reasonably allow for the consequences of the event.
> (b) If the parties fail to reach agreement on these alternative terms within reasonable time, either party may apply to a court or arbitral tribunal in order to have the contract
> adapted to the changed circumstances (provided the applicable procedural law allows for such adaptation), or

56 <http://www.trans-lex.org>.

terminated at a date and on terms to be determined by the court or arbitral tribunal.

Every aggrieved party contended that this legal framework should apply to all the contracts affected by the dramatic fall in interest rates (especially the 'Euribor') subsequent to the 2008 world financial crisis.

Within the Portuguese context, there was a heated debate, especially among scholars who were asked to give their legal opinion in several cases brought to courts.[57]

While for some, regarding the situation following the financial crisis and the particular case of the swap contracts under analysis, the requirements of hardship could not be met,[58] for others the fall in interest rates subsequent to the financial crisis amounted to a hardship situation, allowing the termination or adaptation of the contract.[59]

The Portuguese Supreme Court of Justice held these views in a decision of 10 October 2013, thus confirming a decision of the Guimarães Court of Appeal of 8 March 2012. The particulars of this case are worth mentioning.

In fact, the courts considered a factual background where the swap contract had been entered into between the parties at a time (second half of 2008) when the Euribor interest rate (3 months) was climbing from 4.40%. In consideration of that climb, the parties set forth a 4.55% Euribor indexed interest rate with a 3.95% floor and a 5.15% cap. That is, according to this contract, within the 3.95%/5.15% collar, the interest rate would be fixed at 4.55%. If the Euribor interest rate fell below 3.95% or climbed above 5.15%, the client and the bank, respectively, had the right to terminate the contract immediately. By June 2009, the interest rate had already fallen below 3.95%. In fact, the three months Euribor interest rate was far below 1.50% (1.266%), which meant that for a notional value of €600,000 in the particular case, the client had already to pay the bank more than €6,600. The Supreme Court interpreted the variation between 4.55% and 5.15% as the risk the bank was 'tolerating' from 2008 onwards. By the same token, the risk tolerable to the client was within the range of 4.55% down to 3.95%.

In any event, notwithstanding the fact that the three months Euribor interest rate had climbed above 5.15% after the conclusion of the swap contract at hand (reaching 5.395% by 9 October 2008), by the time the client terminated the contract the interest rate had already gone below 1.266%, which represented a dramatic drop in an eight-month period.

That fall, in the eyes of the Supreme Court, led to losses of extraordinary proportions, thus producing a serious imbalance between the parties to the contract, not covered by the typical risks of that kind of contract. Accordingly, the principles of good faith could not tolerate that the client should endure those losses. Hence, there

57 de Freitas (n 47).

58 See Mota Pintoand da Silva (n 31).

59 de Freitas, in Revista da Ordem dos Advogados, Lisbon, October–December 2012 (n 47) <www.oa.pt/upl/%7B24d07a7e-a1e3-4f43-b06a-300e112c9896%7D.pdf>.

was an extraordinary change in circumstances that allowed the client to terminate the contract.

This decision is very important to bear in mind when addressing the merits of the cases related to swaps. First, the swap contract was entered into in the last quarter of 2013. Secondly, this was a decision made by the Portuguese Supreme Court, affirming a decision of a Court of Appeal. Thirdly, the factual background seems to be compelling: if we take into account that the relevant drop in the interest rate occurred between the end of 2008 and June 2009, a fall from 4.55% (and subsequently from 5.395%) down to 1.266% is impressive, to say the least.

However, it remains to be seen whether this drop 'could not reasonably have been taken into account', whether it 'fundamentally alters the equilibrium of the contractual obligations, thereby rendering the performance of the contract excessively onerous' and, lastly, whether that drop was not covered by 'express stipulation or by the nature of the contract' or whether the risk of that event was assumed by both parties.

All these questions will certainly depend on the circumstances of the case. In any event, we should all be worried, not regarding the use of arbitration, but certainly regarding the questions of 'hardship' that may arise therefrom.