

SIDRU Judgment: Hedging Transaction Not Rendered Speculative Even if It Exposes Party to Unlimited Risk

IN SHORT

The Context: In the wake of the Saint-Leu-la-Forêt decision of May 28, 2018, France's Court of Cassation issued an important decision on structured swaps concerning legal actions brought by public authorities against banks that had marketed these products.

The Outcome: The Court fully rejected the claims of Saint-Germain-en-Laye SIDRU (*Syndicat Intercommunal de Destruction des Résidus Urbains*) against Depfa Bank plc.

The Impact: The Court's September 5, 2018, judgment has many lessons on the concept of inherent risk derivatives transactions and the concept of speculation in the provision of investment services.

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The SIDRU of Saint-Germain-en-Laye has finally lost its case. This household waste treatment syndicate of several municipalities in the western region of Paris took legal action against Depfa Bank plc in May 2011 and did not hesitate to publicize its case against so-called "toxic" swaps. France's Court of Cassation, however, has put an end to this legal action by dismissing SIDRU's appeal of the November 4, 2016, decision by the Paris Court of Appeal.

The Court of Cassation's September 5, 2018, ruling is a landmark ruling in derivatives litigation, focusing in particular on structured swaps and, more broadly, the provision of investment services by banks.



This innovative ruling is premised on the purpose of the concluded transaction. It does not matter that the transaction has a random nature (which is the very nature of a swap contract) and that the risk was unlimited in this case.



SIDRU had filed two actions against the swap marketed by Depfa in June 2007, a few months before the outbreak of the financial crisis: (i) an action to nullify the structured swap because SIDRU claimed it had mistakenly engaged in a speculative transaction and that the bank had committed a fraud by allegedly concealing an option embedded in the interest rate formula; and (ii) an action for damages, alleging that the bank had breached its obligation to disclose relevant information to an unsophisticated investor, which SIDRU claimed to be.

The Court denied SIDRU's claims in their entirety; instead, SIDRU was ordered to pay approximately €20 million, including both the unwinding costs of the swap and unpaid amounts owing to the bank. An examination of the evidence showed that the mayor of Saint-Germain-en-Laye himself had capped the rate of the swaps' structured formula by telephone. The telephone records also provided evidence that the mayor himself had set the risk coefficient that he considered reasonable for SIDRU.

In the lower courts and on appeal to the Court of Cassation, SIDRU argued that the swap transaction did not meet the criteria of a hedging transaction as defined by the accounting regulations, and it relied on several expert opinions in support of its allegations. The Court of Cassation was asked to decide whether or not a hedging transaction must remain free of risk to avoid being transformed into a speculative transaction.

The Court held that "the conclusion of an interest rate swap contract constitutes a hedging transaction and not a speculative transaction when its purpose is protection against the evolution of rates and the reduction of the overall cost of a debt, even if such a contract has an inherent random nature and its conclusion may expose one of the parties to unlimited risk."

This innovative ruling is premised on the purpose (the "goal") of the concluded transaction. It does not matter, according to the Court of Cassation, that the transaction has a random nature (which is the very nature of a swap contract) and that the risk was unlimited in this case.

In a second ruling, the Court acknowledged that the swap at issue did not constitute a unilateral promise to sell or buy an asset at a specified price and date but was, in fact, a mutually agreed structural indexation based on a difference between two exchange rates. Noting the necessarily unpredictable nature of the evolution of the two referenced currencies (the U.S. dollar and the Swiss franc against the

euro), the Court concluded that SIDRU had failed to demonstrate the existence of any alleged unfunded call option and had failed to produce any evidence of fraud ("dol") by the bank.

Finally, the Court held that the bank had met its disclosure obligations to inform SIDRU, which, on the basis of the telephone records provided, the Court determined to be an informed investor.

Jones Day represented Depfa Bank plc in the Saint-Germain-en-Laye SIDRU case.

THREE KEY TAKEAWAYS

1. The conclusion of a swap aimed at protecting against rate changes and reducing the overall cost of debt is a hedging transaction and not a speculative transaction.
2. Even if the transaction has an element of unlimited risk, that does not render the transaction a speculative operation.
3. The production of telephone recordings may be used as a form of proof, in this case when it is necessary to show that a bank's counterparty is a well-informed investor.



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