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Interest Rate Swap Agreements: Draft Information Letter of the Russian Supreme Commercial Court

This alert discusses the recently published[1] Draft Information Letter of the Presidium of the Russian Federation Supreme Commercial Court (the "SCC") entitled "Dispute Resolution Issues Arising out of Interest Rate Swap Agreements" (the "Draft"). The proposed recommendations of the SCC relate to such aspects as the formation, amending and termination of interest rate swap agreements, conformity of their performance to the purpose of their conclusion, pre-contractual disclosure concerning the nature and intended effects of such type of agreements.

Current interest in these matters is explained by the outcome of two recent cases considered by the Russian courts (the Agroterminal and Hermitage Development cases[2]) in which the unilateral termination of interest rate swap agreements without any payment or compensation by the terminating party to the other party was found to be lawful. In addition, the interest is due to the numerous foreign court decisions related to the principle of protection of non-professionals' rights in the financial market.

The Impact of Recent Disputes concerning Derivative Transactions on the Legal Position of the SCC

Interest rate swap agreements concluded under the Russian law are regulated by the legislation on the securities market[3] and general provisions of the Civil Code of the Russian Federation (the "Civil Code") on the making of agreements (Articles 432 and 433 of the Civil Code) and on the termination of obligations (Articles 408 and 407 of the Civil Code). For example, the courts applied these general provisions of the Civil Code in the Agroterminal and Hermitage Development cases.

The Draft provides for the introduction of a requirement whereby early termination of a master agreement (general agreement) made with respect to swap transactions is only possible where the parties do not have a continuing legal relationship arising out of swap transactions. Early termination of certain swap transactions is permitted either by agreement of the parties or on grounds provided for under applicable law or contract (Clause 2 of the Draft).

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1 The publication was posted on 17 September 2013 on the website of the Russian Federation Supreme Commercial Court (the "SCC") *http://arbitr.ru/_upimg/957CCFD549A7380EE23DEA9807CA97B9_Проект_ИП_своп.pdf*

2 The SCC Ruling refusing referral to the SCC Presidium of case № ВАС-3788/2013 dated 23 May 2013 (the "Agroterminal case") and the SCC Ruling refusing referral to the SCC Presidium of case № ВАС-15181/12 dated 23 November 2012 (the "Hermitage Development case").

3 Federal Law No. 39-FZ "On the Securities Market" dated 22 April 1996 (the "Securities Market Law") and Regulations on the Types of Derivative Financial Instruments approved under Russian Federation Federal Service on Financial Markets (the "FSFM"), Order No. 10-13/пз-н dated 4 March 2010.

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This approach does not conflict with current regulation on the procedure for terminating derivative transactions as laid down in the standard documentation for derivative transactions on financial markets, with due regard for the amendments approved in December 2012[4].

The Draft states that if an interest rate swap agreement is terminated early, the parties are to calculate the final amount (close-out amount) in accordance with the procedure provided for under the agreement. Such calculation is to be made on an early termination date. The debtor identified as a result of such calculation is to pay the final amount (close-out amount) to its counterparty. The obligation to make the final payment can be terminated either by proper performance or on the basis of other grounds under the applicable law or contract.

This provision aims to resolve the key issue of the existence of payment obligations between parties to an interest rate swap agreement, not only on but also prior to the payment date. The Draft implies a positive answer to this question. This differs from the position taken by the courts previously in the Agroterminal and Hermitage Development cases, in which the courts deemed it possible to terminate interest rate swap agreements prior to the payment date without making calculations between the parties. This was on the basis that there was a contractual provision that either party may terminate the agreement unilaterally at any moment provided that there are no outstanding contractual obligations.

The Draft confirms the statutory[5] right of the parties to apply to their legal relationship the standard terms of agreements concerning derivative transactions in financial markets (Clause 3 of the Draft). This provision is complemented by the rule that amendments made to the standard terms shall only apply to the relations arising out of the agreement if this is directly agreed by the parties. Therefore, the amendments to the standard terms as published in December 2012 do not automatically alter the terms of agreements made based on and referring to the previous version of the standard terms. Nor are such agreements subject to the arbitration clause provided for under the latest amendments to the standard documentation.

Pre-contractual Disclosure by Financial Market Professionals

The Draft requires financial market professionals ("professionals") to disclose to their non-professional clients information concerning the forthcoming transaction and its likely economic and legal consequences (Clause 4 of the Draft). This requirement fits with the principle of protecting the weaker party to a transaction. This is not expressly provided for in the Civil Code but is applied in the interpretation of provisions relating to accession agreements, public agreements, as well as statutory provisions on consumer rights and other provisions. According to the latest trends of the SCC's practice, this principle may be taken into account by the courts when considering dispute resolution cases[6].

The new requirement is not fully embodied in statute, nor is its legal nature clear, as it concerns pre-contractual relations which, as a general rule, are not afforded the protection of the law.

As noted above, this requirement only applies to professionals. According to the Draft, these are persons who either enjoy the status of a qualified investor as per Article 51.2 of the Securities Market Law or may be so qualified in accordance with the criteria specified in Clauses 4 and 5 of the above article (criteria of the total amount of obligations, quantity, amount and deadline of the transactions, the amount of equity, earnings, total assets, etc.).

A professional failing to comply with disclosure requirements faces a potential claim from a non-professional client for termination of the agreement and for damages. According to the Draft, for the Claimant to be successful in such instances, it must prove the following complex of facts: *first*, the Respondent is a professional; *second*, the Respondent acted in bad faith; *third*, the Respondent concealed the degree of risk involved and that the degree of risk was higher than was objectively prepared for; and, *forth*, the outcome of the transaction failed to meet the Claimant's reasonable expectations.

4 The standard documentation is posted on the website of the National Association of Capital Market Participants (NAUFOR) *http://spfi.info/*. Standard terms of the agreement on derivative transactions in financial markets were approved under the FSFM Order No. 11-3600/пз-н dated 28 December 2011.

5 Clause 3 of Article 51.5 of the Securities Market Law.

6 The principle of protection of the weaker party to a transaction has become widespread in the resolution of *disputes in investment construction*. Specifically, in its Resolution No. BAC-13239/12 dated 23 April 2013 (the Gagarinets case), the SCC Presidium noted that the principal purpose of the approval of special rules on the bankruptcy of developers is to ensure the priority protection of non-professionals in construction projects as non-professional investors. Guided by this purpose, the SCC Presidium resolved the dispute in favor of the non-professional investor. Similarly, the principle of protection of the weaker party to a transaction was applied in the SCC Presidium Resolution No. BAC-15510/12 dated 12 March 2013.

In the resolution of *financial disputes*, the latest trend has been to apply a principle close to the above but interpreted more broadly called the principle of parity (balance of interests) in the parties' relations. Specifically, in its Resolution No. BAC-8983/12 dated 30 October 2012 (the Alfa Bank case), the SCC Presidium, based on this principle, concluded that the rights of the borrower may not be infringed even if it breaches its obligations under the loan agreement. Therefore, as liability is imposed on the borrower, account is to be taken not only of force majeure but also of other actual and legal circumstances of the case.

The exact form and extent of the disclosure requirement are still debatable. For example, it is already the case that Russian banks make their clients confirm that they understand the terms and effects of the transaction, i.e. they currently formally comply with the disclosure requirement. In addition, it is difficult to trace information affecting the consequences of a transaction, given the constant changes in financial markets.

It is not hard to envisage that if this provision is adopted, the principle of disclosure may become a universal requirement in transactions made by professionals.

The Draft provides that this novel provision will only apply to relationships arising out of agreements entered into after the information letter is published (Clause 6 of the Draft).

Conformity of an Interest Rate Swap Agreement to its Purpose

According to the Draft, an interest rate swap agreement may be related to a contract, the risks of which are hedged using such interest rate swap agreement. The court may resolve that minimizing interest rate and currency risk under, for example, a loan agreement, is the principal purpose of an interest rate swap agreement. In such instances, if performance of the interest rate swap agreement fails to conform to the purpose ascertained and the terms of the hedging contract fail to materialize, are amended or terminated, a party to the agreement may file a claim either to amend or to terminate the interest rate swap agreement. This is provided that the other party is reimbursed for the costs related to such amendment or termination. In applying the grounds for amendment or termination, the court will have to consider the interests of both parties (Clause 5 of the Draft).

The above provision applies in instances where the interest rate swap agreement and the related hedging contract are made between the same parties. This considerably restricts the use of such grounds for termination or amendment because, in practical terms, such transactions often involve different parties (for example, banks, swap dealers).

This is a novel provision in Russian law and gives rise to a number of questions. For example, how are reimbursements to be determined and how will this correlate with the final payments when the agreement is terminated.

The Draft is not yet a court act of the SCC and is therefore not binding. The SCC Presidium will discuss it on 24 October 2013.

We will monitor the publication of the information letter and will update you on its final version.