



November 1, 2013

## Supreme Court enables termination of swap agreement based on “*change of circumstances*”

On 10 October 2013, the Portuguese Supreme Court (“**SC**”) unanimously confirmed two decisions from lower courts which declared the termination of a swap agreement entered into in 2008 between a clothing company (the “**Plaintiff**”) and a financial institution. This decision, which does not set a binding legal precedent, acknowledged the Plaintiff’s right to terminate the agreement, with effect from January 2009, then the Plaintiff first gave notice of that intent to the financial institution, consequently condemning the latter to return to the Plaintiff all payment made since that date.

The relevant swap agreement, described in the decision as possessing the features of an interest rate collar, was connected to a loan granted by the financial institution to the Plaintiff, which accrued interest at a variable rate. The swap had a collar between 3.95 and 5.15 per cent. for 3M Euribor. When 3M Euribor dropped below 3.95 per cent., the Plaintiff was out of the money, and the financial institution charged the relevant amounts (although it had not paid to the Plaintiff the amounts corresponding to the interest rate when it rose above 5.15 per cent.).

The Plaintiff sought to terminate the agreement unilaterally, only to be informed that to do so it would have to pay compensation to the financial institution. Refusing to conform, the Plaintiff then went to court, seeking to terminate the agreement without charges and to receive the amounts debited hitherto.

As had lower courts before it, the SC did not declare the swap agreement void nor accepted to annul it based on an error by the Plaintiff as to the purpose of the agreement, but it did acknowledge the Plaintiff’s right to terminate the agreement based on a “*change of circumstances*”.

This Portuguese law mechanism (applicable only to Portuguese law agreements, although other jurisdictions, namely civil law jurisdictions, possess similar mechanisms) allows the party most harmed by an abnormal change in the circumstances on which it based its decision to enter into an agreement the chance to terminate or modify that agreement based on material fairness criteria. For that to happen, it is necessary that, due to the relevant abnormal changes (which must be outside the influence of the parties), the enforcement of a party’s obligations affects bona fides and is not covered by the risks inherent to the contract in question.

It should be noted that this judgement is based on a specific set of facts summarily described in the decision and which the SC considered when analysing the claim. The SC ruled that it was not “tolerable” (sic) that the Plaintiff was forced to pay for the rate dropping below 3.95 per cent. when the financial institution might not be forced to pay for the rate rising above 5.15 per cent., thus acknowledging a possibility of termination which was not set out in the agreement but was dictated by the change of the circumstances on which the agreement was based.

For the SC, in line with the appealed rulings, that change was the drop in 3M Euribor from the beginning of 2009 onwards, which did not constitute a risk inherent to the contract in question both because of its extent and because of the reasons leading to it.

As mentioned above, this decision applies only in relation to an agreement entered into by a non-qualified investor, and does not set any kind of legally binding precedent. However, the use of the “change of circumstances” mechanism in a case such as this allows lower courts, as well as the legal community in general, to be aware of the possible stance which the SC could adopt in future situations where a party intends to attribute to the current economic environment an exceptional nature capable of justifying the termination or substantial changes to a contract of this nature, when that is demandable based on fairness criteria.

A window for some uncertainty is thereby opened, bringing into the fray a general legal principle which is always difficult to quantify, in a matter which is certain to develop further as more judicial decisions come up.

We will continue to monitor any developments with regard to this situation.

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**Note:** The above is based exclusively on the text of the decision, with no access to any other elements of the legal suit, in which VdA has not participated in any capacity. The above should not be construed as containing legal counselling of any nature regarding the subject matter at hand, corresponding only to our interpretation of the decision, and does not preclude the need to obtain actual legal counsel in order to analyse any position in agreements of this nature.

### LISBON

Av. Duarte Pacheco, 26  
1070-110 Lisboa Portugal  
lisboa@vda.pt

### OPORTO

Av. da Boavista, 3433 - 8º  
4100-138 Porto Portugal  
porto@vda.pt

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