

P.R.I.M.E. Finance

Panel of Recognized International Market Experts in Finance

FINANCIAL MARKET REGULATION: EVER EVOLVING AND EVER PRESENT



P.R.I.M.E. FINANCE
Panel of Recognised International Market Experts in Finance



Presentation by Antoine MAFFEI
2017 P.R.I.M.E. Finance Annual Conference
23 & 24 January, Peace Palace, The Hague

SO CALLED “TOXIC LOANS” TO LOCAL GOVERNMENTS – FRANCE

The legal Regime of Financing Services to French Local Governments

- ❑ Core Principles contained in government circular of June 25, 2010:
 - Wide level of autonomy governed by decentralization legislation enacted in 1982
 - That autonomy applies to both loan transactions as well as to financial instruments, including derivatives
 - A local government is not necessarily categorized as a professional client
 - No speculative transactions are expected to be incurred
 - A duty of information exists upon the credit institution or investment services provider according to the product
 - A local government has to comply with mandatory administrative law requirements including *inter alia* the need to comply to deposit available funds with the French Treasury



ADMINISTRATIVE ASPECTS

- The council of elected representatives of the public borrowing entity or counterparty has the authority to approve transactions prior to their conclusion
- That authority may be delegated to the executive body's (mayor – president, etc) and has to be drafted in clear terms and that delegation is limited in time
- Transactions are subject to the control of the relevant elected council



CONTROL BY THE GOVERNMENT SERVICES (THROUGH THE “*PRÉFETS*”)

- ❑ Reporting
- ❑ Legality control (absence of council approval or delegation of authority by the council may lead to nullity)
- ❑ Budget control by the Préfet
 - Control of regularity
 - Advisory role of the authority
- ❑ Accounting control



SO-CALLED “TOXIC TRANSACTIONS”

- ❑ Since the 90’s, a number of municipalities' indebtedness has taken the form of structured loans
- ❑ Those were not necessarily using as a benchmark “EONIA” or “Euribor” references but interest was calculated by formulas using an index, inflation rates, foreign currencies (in particular the Swiss Franc), etc ..
- ❑ Municipalities became therefore exposed to contingent risks on account of increased interest payments in the aftermath of the financial crisis of 2008 and the resulting economic downturn
- ❑ In order to alleviate the burden of exposed municipalities, the 2014 Budget law created a Euro 3 billion Support Fund to be allocated to interest support and refinancing cost to convert the loans to a fixed interest rate facility (Guarantee Fund)
- ❑ Most affected municipalities used that option leaving a small minority which elected to move to a contentious approach



SO-CALLED “TOXIC TRANSACTIONS”

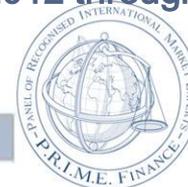
- ❑ One of those affected municipalities (“Saint Cast le Guildo” in Brittany) (the “Municipality”) had contracted with DEXIA Credit Local in 2007 for a principal amount of Euro 3.623.059,13 (the “Loan”), with the following characteristics:
 - Maturity 28 years (July 2035)
 - Interest:
 - ❖ first phase ending July 1, 2008 : fixed annual interest rate set at 3,99%
 - ❖ second phase ending July 1, 2032 : floating rate according to a contractual formula including a reference to the Swiss Franc, the triggering rate of which was set at 1,44 (if the Swiss Franc parity with the Euro was in excess of 1,44 at the end of a relevant interest period, an annual 5,18% fixed interest rate was set, and if that parity was lower, a formula was triggered with a reference fixed interest rate of 7,18%)
 - ❖ third phase – 12 months Euribor with 0,00% margin
 - The Loan purported to refinance a number of transactions, some of which were structured loans
 - Early Termination make whole amount :
 - ❖ the contract provided for a prepayment indemnity calculated as the arithmetic mean of market quotations provided by two designated market participants
 - ❖ the purpose of that clause was to assure the financial equilibrium of the contract between the two parties, DEXIA having purchased derivatives to cover its positions



LITIGATION BEFORE THE TRIBUNAL DE GRANDE INSTANCE DE NANTERRE

- The Municipality sued DEXIA and CAFFIL (a société de crédit foncier which had purchased the Dexia Claim against the Municipality) on May 31 2011 on various grounds, including *inter alia*:
 - Nullity of the Loan on account of gross misrepresentation (“dol”)
 - On an ancillary basis
 - ❖ Damages on account of interest paid in respect of interest rate provisions the nullity of which was sought
 - ❖ Payment of Damages on the ground that Dexia had not complied with its duty of disclosure and information regarding the transaction related to the Loan
 - ❖ Nullity of the Prepayment indemnity

- By judgement of June 26, 2015, the court rejected all the demands of the Municipality with the exception of :
 - The damage claim on account of failure by DEXIA to comply with its duty of disclosure and obligation to warn the Municipality of the potential adverse exposure in respect of which an amount of Euro 826 260 awarded in favor of the Municipality
 - Such amount to be set-off against a payment obligation of the Municipality in the amount of Euro 1 500 946,30 on account of unpaid interest for the years 2012 through 2014



DISMISSAL OF NULLITY CLAIM OF GROSS MISREPRESENTATION

- ❑ Characterization of the Loan as a structured borrowing consisting of a mix of fixed rates components and financial instruments (including a foreign exchange option) which leads to the conclusion that the product included speculation features
- ❑ That characterization was disputed by DEXIA which supported the fact that, despite the interest calculation formula, the facility remained a loan and that extension of that loan could not be characterized as a an investment service



DUTY OF A BANKER – THE COURT HELD :

- ❑ Referring surprisingly to the statutory provisions transposing relevant MIFID provisions in the French Monetary and Financial Code defining financial instruments, the court concluded that the Loan constituted a loan including financial risks but not financial instruments - therefore MIFID obligations did not apply
- ❑ However, based on Article 1134 of the Civil Code, a banker is vis à vis a non-professional borrower (*non averti*) subject to a reinforced duty of information purporting to make the borrower aware of a risk of manifest excessive indebtedness or leading to repayment difficulties
- ❑ The facility contained manifest financial risks resulting from the interest calculation formula including an index and a multiplier (which the court mischaracterized)
- ❑ The court dismissed the DEXIA's arguments which pointed out that the Municipality had since 2004 entered into multiple variable interest rate facilities as well as financial restructuring arrangements regarding its facilities on the ground that :
 - The relevant facility was to be characterized as a structured variable interest rate facility of a particular nature :
 - ❖ including complexities and specific risks
 - ❖ which can only be understood after a full understanding of the mechanics of the interest rate formula, its parameters and resulting risk



DUTY OF A BANKER

❑ Gross Misrepresentation (Dol)

- Under the provisions of Article 1116 of the Civil Code, a contract may be voided on the ground of “*Dol*” when manoeuvres used are of such a nature that without such manoeuvres the other party would never have contracted “*Dol*” has to be proved and cannot be presumed
- The Municipality alleged :
 - ❖ Aggressive marketing from Dexia, which delivered in January 2007 a presentation wrongly describing the transaction as “secure product” while omitting to describe the true nature of the product to induce the Municipality to conclude the transaction, thereby subjecting it to an excessive make whole termination amount permitting the bank to increase its margin and resulting in an unlimited risk for the Municipality
 - ❖ Dissimulation by the bank of its margin and omission to provide the sensitivity tests



DUTY OF A BANKER

- ❑ Dexia contested that the January 2007 document produced by the Municipality (which included about 20 pages) was the one delivered on January 22, 2007 by DEXIA which included about 40 pages and included an offer of 5 types of products including sensitivity tests related thereto
- ❑ The court ruled that :
 - There was a question about the presentation of the document submitted and that it may be possible that the document may have been manipulated
 - It is not established that the document produced by the Municipality is the one delivered on January 22, 2007 which included sensitivity tests and a description of the evolution of the Euro/Swiss Franc exchange rate over the years
 - Therefore, the lack of sensitivity tests allegation of the Municipality was not retained
 - The Court dismissed also various other allegations of the Municipality on the ground of “*dol*” and concluded that there was no wrongful intention by DEXIA which may justify avoidance of the transaction



DUTY OF DISCLOSURE AND LIABILITY OF THE BANK

□ The Court held, however, that :

- Failure to its duty of disclosure and warning described above, although not constitutive of a “*dol*”, is susceptible to trigger DEXIA’s liability, as the risks related to the appreciation of the Swiss Franc which had not been disclosed did materialize
- Mitigating factors have, however, to be taken into account in calculating damages on account of loss of opportunity (“*perte de chance*”) not to contract

□ Those mitigating factors (valued at 50% of the loss of opportunity) to be taken into account include :

- The brutal effect of the occurrence of the 2008 financial crisis which had not been anticipated
- Prudence should have let the Municipality not to contract such a complex and opaque instrument
- Should it not have contracted then, it would likely have been bound to pay a higher rate of interest
- Taking into account those mitigating factors, damages retained have been set at Euro 826 260



THE APPEAL JUDGMENT OF THE COURT OF APPEALS OF VERSAILLES OF SEPTEMBER 21, 2016

- ❑ The Municipality appealed that decision (subject to the damage award in favor of the Municipality, confirmation of the Judgement being in that respect requested)
- ❑ DEXIA and CAFFIL requested confirmation of the judgment and reversal of the damage decision in favor of the Municipality



CONFIRMATION OF THE DISMISSAL OF THE DEMAND OF THE MUNICIPALITY RELATED TO ALLEGED GROSS MISREPRESENTATION LEADING TO NULLITY OF THE TRANSACTION

The Court of Appeal confirmed the dismissal of that cause of action but on different grounds :

- The facility under consideration did not constitute a speculative transaction *nor did it include financial instruments nor options*
- The rate of interest for phase two and three were clearly and precisely defined
- Where the qualification of a Municipality as professional *cannot be presumed that qualification must be analyzed as of the date of conclusion of the contract*. The court concluded that the Municipality was a *professional* and reversed the earlier judgement in that respect. It was noted that :
 - ❖ The facility purported to refinance antecedent outstanding facilities
 - ❖ The Municipality used to practice an active management of its outstanding facilities
 - ❖ The deputy mayor in charge of finance of the Municipality was director of the local branch of a substantial banking institution
 - ❖ The Municipality, although small, had concluded about 40 transactions over the years to finance substantial projects (including a port for private vessels) with DEXIA plus others with other financial institutions
 - ❖ The Municipality did not have recourse to the special advisory services of the local Préfecture in charge of advising Municipalities in respect of contracting loans



CONFIRMATION OF THE DISMISSAL OF THE DEMAND OF THE MUNICIPALITY RELATED TO ALLEGED GROSS MISREPRESENTATION LEADING TO NULLITY OF THE TRANSACTION

In respect of the Alleged Gross Misrepresentation (“Dol”) the Court noted :

- ❑ It was not in the interest of DEXIA to trigger financial difficulties for the Municipality which would have affected materially its repayment capacity
- ❑ The Municipality did not provide evidence of characterized maneuvers or misrepresentation through reluctance or omission
- ❑ Documents delivered to the Municipality show that :
 - The floating rate features of the loan facility during phase 2 and 3 had not been hidden
 - The fact that documents produced sensitivity tests therein included did not contemplate a worst case scenario (which in fact occurred) in respect of the Euro/Swiss Franc currency fluctuations, does not per se constitute a misrepresentation maneuver
 - The level of margin of the bank does not have to be disclosed
 - The municipality does not demonstrate economic violence by Dexia as the Municipality conducted business with other financial institutions and had offered different formulas to renegotiate outstanding credits in 2007
 - Reference in the marketing documentation to the Swiss Franc as a safe harbor currency (*valeur refuge*) does not per se constitute a lie, as this statement was supported by charts illustrating the economic situation at the time of closing of the transaction



PRECONTRACTUAL DUTY OF DISCLOSURE AND RESULTING LIABILITY : REVERSAL OF THE DECISION OF THE LOWER COURT

□ DEXIA argued that the Municipality being assimilated to a professional :

- was only bound to verify that the loan made available did not create a risk of excessive over - indebtedness;
- taking into account its financial capacity; and

was therefore not under the duty to warn the Municipality

No evidence of a situation of over - indebtedness was produced



PRECONTRACTUAL DUTY OF DISCLOSURE AND RESULTING LIABILITY : REVERSAL OF THE DECISION OF THE LOWER COURT

□ The Court of Appeal held that :

The Municipality being a professional which produced no document related to its budget or its indebtedness did not establish:

- that the facility created an excessive level of indebtedness with regard to its financial capacity
- nor that DEXIA was in possession of information relate to the anticipated repayment capacity of the Municipality not otherwise held by it

□ Therefore, Dexia :

- was under no duty :
 - ✓ of warning;
 - ✓ or advising the Municipality
- was under the sole obligation to disclose comprehensively to the Municipality the characteristics of the loan and of the risks incurred in order to shed light in the context of contractual obligations under consideration
- delivered to the Municipality, through its authorized representatives, all documents and essential elements required for its comprehensive information
- while having obviously an interest in the conclusion of the transaction was not under the duty to disclose its margin



PRECONTRACTUAL DUTY OF DISCLOSURE AND RESULTING LIABILITY : REVERSAL OF THE DECISION OF THE LOWER COURT

□ As a result:

- The MIFID related duty of disclosure raised by the Municipality is not applicable to the disputed Loan being as that Loan does not include an investment product and has no speculation features
- The decision of the lower court has been reversed in this respect together with related demands of the Municipality



EARLY PREPAYMENT INDEMNITY

- ❑ The Municipality sustained that that early repayment indemnity :
 - Was void as being potestative pursuant to the provisions of the civil code and breached the financial equilibrium of the transaction between lender and borrower
 - On an ancillary basis, that the relevant clause was abusive and therefore void



EARLY PREPAYMENT INDEMNITY

□ The Court of Appeal held :

- That the contract did not contain a potestative condition within the meaning of Article 1170 of the Civil Code as :
 - ❖ Payment of the indemnity does not exclusively depend of the discretion exercised by the lender
 - ❖ While the make whole amount level is not determined in the contract, it is determinable under its terms and conditions
- Therefore, the demand of the Municipality in this respect has been rejected confirming the earlier judgment in this respect
- The clauses if the consumer code only apply in respect of the relationship between professionals or consumers and/or non professionals
- The non professional characterization does not apply to the Municipality



EARLY PREPAYMENT INDEMNITY

- The Municipality did not demonstrate the disproportionate character of the make whole amount, the fact that the make whole amount at the time of exercise of the prepayment option (prepayment has not been requested) may be about double the amount of principal, the principal amount of the loan is not sufficient to establish an imbalance
- The purpose of that indemnity is to indemnify the bank for loss of revenue until the term of the loan
- To demonstrate an imbalance, the borrower needs to demonstrate that the indemnity is disproportionate compared with that loss of revenue, which has not been demonstrated
- That the Municipality demand had to be rejected

