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May 2019

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An Italian appeals court (Corte di Cassazione) has agreed with the first instance decision last year of the Italian Court of Accounts (Corte dei conti) in concluding,

- **The court had no jurisdiction over a third-party investment bank when entering into derivatives transactions with the Treasury department of the Ministry of Finance of the Republic of Italy in its capacity as manager of the public debt.**
- **The court would not second guess the decision of public employees of the Ministry of Finance to enter into derivatives transactions with investment banks on behalf of the Republic of Italy unless the decisions were clearly irrational or illegal.**

Interestingly, in coming to its well-reasoned judgment, the court gave very little weight to the representations as to capacity and legality given by the Republic of Italy in the ISDA Master Agreement between the parties. The ISDA in this case was governed by Italian law so it remains to be seen whether different significance would be attributed to such representations if the court had to consider an English law governed agreement.

We await to see if the case is appealed to Italy's Supreme Court.

Case Background

The case involved derivative transactions entered into between the Ministry of Finance of the Republic of Italy (in its capacity a manager of the public debt) and Morgan Stanley between 1995 and 2005 which were terminated in December 2011 and January 2012. Morgan Stanley originally entered into the derivative transactions with the Republic of Italy in connection with the Republic of Italy's bond issuance on which it had acted as lead arranger. In total the Prosecutors claimed 2.7 billion euros from Morgan Stanley and, with the sums claimed from ex-employees, this rose to a total claim of approximately 4 billion euros.

The Corte dei conti is a special Italian court that, amongst other things, audits and reviews public accounts and brings cases against government employees whose negligence or wilful misconduct has caused damage to the Italian state. In general, the court only has jurisdiction to bring claims against those who carry out public functions i.e. not third parties. The Prosecutors in this case argued that when an investment bank provides information to the state in connection with derivatives transactions entered into in relation to the management of the public debt it is performing a specialist role and can be viewed as a quasi-public entity and therefore subject to the court's jurisdiction. However, the appeal court agreed

with the first instance court that investment banks functioning as specialists in the management of the public debt are not carrying out any public function and are a mere counterparty of the Republic of Italy when managing issuance of bonds so there is no special relationship to justify an investment bank being seen as performing a public role. Accordingly the court refused to accept jurisdiction.

The prosecutor also attempted to build a case against senior ex-officials in the Italian Treasury which would have rendered them personally liable for any damage caused to the Republic of Italy by their negligence or wilful misconduct. The prosecutor argued that, when entering into derivatives managing public debt, the Republic of Italy does not have capacity to enter into sophisticated trades that are not hedges for the underlying risk of the debt. The claim against the ex-employees was that the swaptions concerned had clear elements of speculation and were therefore outside the capacity of the Republic of Italy. The court found that the decision whether to enter into or close out a particular derivative transaction is governed by Italian business judgment rules such that the court will not second guess the decision made on the merits by the public employees unless the decision was clearly irrational or illegal.