

Transneft vs. Sberbank: judgment on a landmark derivatives case in Russia is published

On 21 June 2017, the Arbitrazh Court of Moscow (the "Court"), as a court of first instance, published the full text of its decision of 8 June 2017 in the Transneft vs Sberbank case (No. A40-3903/17-55-23), in which it upheld Transneft's claim to render invalid certain FX options (the "Decision"). While we believe that the court has reached the wrong conclusion and expect Sberbank to bring an appeal in due course, herein we summarise the key aspects of the Decision. Please note that this summary is based on the wording of the Decision without any assessment of the evidence presented by the parties during the court hearings.

Background

On 27 December 2013, Transneft and Sberbank entered into two FX options pursuant to which:

- a) In consideration for receipt of a premium of around RUB 169 mln, Sberbank sold to Transneft a FX put option to sell to Sberbank around USD 2 bln for receipt of RUB 65 bln ("Put Option"); and
- b) In consideration for receipt of a premium of around RUB 1.3 bln, Transneft sold a FX call option to Sberbank to sell to Transneft RUB 65 bln for receipt of around USD 2 bln ("Call Option", and collectively with the Put Option, the "Options"),

if at any time before 18 September 2015 (the "Expiry Date"), the USD/RUB spot rate exceeded 45.00 (in September 2014 the trade was restructured and the reference USD/RUB spot rate was increased to 50.35).

Both Options were documented under Russian market standard derivatives documentation. While as at the trade date, the USD/RUB rate established by the Central Bank of Russia was 32.67, as a result of geopolitical tensions and a sharp fall in oil prices, by 1 December 2014 the USD/RUB spot rate had increased to 52.62 and subsequently

increased further. Sberbank notified Transneft thereof and on the Expiry Date exercised its Call Option, as a result of which, on 21 September 2015, Transneft paid to Sberbank ca. RUB 67 bln, being the RUB equivalent of the difference between RUB65bln and USD2bln as at such time.

However, in January 2017, Transneft filed a lawsuit to render the Options invalid, arguing that, in selling the Options, Sberbank breached a fundamental requirement of Russian law that the parties to a contract must act in good faith, and that as a result, the Options are null and void.

In particular, Transneft argued that:

- a) Sberbank imposed extremely unfavourable, speculative and high-risk Options on Transneft and missold the Options as a "subsidy to reduce the costs of servicing the coupon on Transneft's RUB bonds";
- b) Transneft did not have the requisite experience of trading in complex derivative instruments and did not have sufficient expertise and skills to independently evaluate the terms and risks of the proposed Options;
- c) when negotiating the trade, Sberbank did not disclose the risks of the trade for Transneft and incorrectly described the Options as the "exchange of two equivalent notional amounts". Consequently, Transneft

argued that as a result of Sberbank acting in bad faith, Transneft did not realise that it assumed significant FX risks in connection with the Options.

Having considered the case, the Court ruled in favour of Transneft.

Analysis

The Court has inferred extreme complexity in a relatively simple FX instrument

The Court has relatively easily established that the Call Option could have been beneficial for Transneft only in the absence of a sharp depreciation of RUB against USD, and that by entering into the Call Option Transneft assumed the risk of FX fluctuations. However, over the last 25 years, the entire Russian market has been commonly exposed to FX risk, and typically Russian courts tend to dismiss lawsuits where debtors try to challenge their increased liabilities due to FX fluctuations (effectively, the Court gave Transneft the protection that has been denied over the last two years to retail customers of Russian banks with foreign-currency denominated mortgages). In addition, Sberbank did refer to FX risks in its presentations to Transneft, but for some reason the Court ignored it and focused more on Sberbank's assessment of the probabilities of different currency movements and effectively imposed liability on Sberbank for having the wrong expectation in this regard. Although the Court did not go so far as to say that Sberbank deliberately gave wrong forecasts to Transneft, it seems to suggest that Sberbank's forecasts should have taken into account a wider range of factors.

The Court imposed a "duty of care" on Sberbank and released Transneft from responsibility for its own actions

The Court took an extremely "paternalistic" approach towards Transneft, a company that (in USD terms) has billions of assets, significant FX and interest rate exposures and a long track-record of trading in derivatives (in particular, with Sberbank for hedging purposes, which Transneft admitted in court). The court effectively released Transneft from responsibility for its own actions, including the responsibility to read and understand the contracts it signs. Instead, the Court imposed a "fiduciary" duty on Sberbank. In particular, the Court stated that, prior to entering into the disputed Options, Transneft and Sberbank

entered into 31 derivative transactions representing different combinations of put and call FX options and Sberbank gave advice to Transneft in respect of all those transactions. Accordingly, the Court accepted Transneft's argument that, as a result of these "long term fiduciary relationships, Transneft viewed Sberbank more as its trusted advisor, rather than an independent counterparty to a contract". Accordingly, the Court stated that Transneft did not have any reason to doubt the information provided by Sberbank prior to entering into the disputed Options. The Court was also sympathetic to Transneft's arguments that Russian market standard documentation is inherently complex and difficult to understand for a non-professional and that none of the marketing materials provided by Sberbank, or any correspondence between Transneft and Sberbank, contained references to specific clauses of the market standard documentation that would apply to these Options, which further complicated the understanding of the Options for Transneft.

Moreover, the Court referred to the standards of care established for local brokerage business by Russian industry bodies as a standard that Sberbank was supposed to follow. Thus, the Court has effectively blurred the lines between the transactions entered into between banks and corporates on a principal-to-principal basis and transactions where banks act as brokers or fiduciaries for their corporate clients.

The Court has put greater emphasis on product presentations rather than legal documents

In assessing whether Sberbank acted in good faith or not, the Court went to great length to examine the pre-trade conduct of the parties and four presentations on the trade prepared by Sberbank for Transneft from January to December 2013, and found them misleading and inconsistent. In particular, the court concluded that the Call Option was marketed to Transneft as a suitable instrument to "reduce the cost of servicing Transneft's Rouble bonds coupon", which persuaded Transneft that in consideration for assuming a very remote risk of a sharp decline of RUB against USD, Transneft would receive a significant premium for the Call Option which could be applied towards servicing the coupon. However, the Court concluded that (i) Sberbank misstated the probability of Rouble depreciation and the associated risks for Transneft, (ii) the Call Option had no direct correlation with servicing the RUB bonds, (iii) Sberbank failed to explain to the court its own rationale for

entering into the Put Option and Call Option with Transneft; and (iv) as a result of exercising the Call Option, Sberbank received "excessive profits". The Court also stated that the actual "declaration of risks" was provided by Sberbank to Transneft too late (eight days before the actual trade date).

The statute of limitations

One of the issues that was raised in the Decision was whether a breach of the duty to act in good faith renders a transaction void or voidable, as this was relevant for determining whether the statute of limitations has lapsed. The Court has expressed a view that such transactions are void. As a consequence, the Court has applied the three year statute of limitations (instead of one year, that would have been applicable had the Court ruled such transaction voidable).

Summary & Conclusions

The Decision follows on from the 2016 precedent of Platinum Real Estate vs Bank of Moscow (case No. A40-168599/2015). In that case as well as this, relatively simple FX derivatives were voided on the basis that the banks had acted in bad faith vis-a-vis unregulated corporate counterparties. Although the determination of whether a person acted in bad faith is highly dependent on the facts and circumstances of each particular case, there seems to be a worrying pattern that, when confronted with derivative transactions, Russian state courts tend to assume they are inherently complex and feel the urge to grant to a corporate entity legal protections exceeding even those that may be available to retail consumers. At the same time, the Decision suggests that banks' communications with their clients both prior to, and also in the course of, a trade will be subject to a high level of scrutiny. In light of such a "hostile" approach from the Russian courts, banks may need to more carefully approach their communications with clients, and to consider more suitable dispute resolution venues.

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