Neutral Citation Number: [2018] EWHC 1935 (Comm)

Case No: FL-2017-00007

IN THE HIGH COURT OF JUSTICE
THE BUSINESS AND PROPERTY COURTS OF ENGLAND & WALES
COMMERCIAL COURT (QBD)
FINANCIAL LIST

Royal Courts of Justice
Strand, London, WC2A 2LL

Date: 25/07/2018

Before :

MR JUSTICE ROBIN KNOWLES CBE

- -

Between :

THE STATE OF THE NETHERLANDS	**Claimant**
- and -	
DEUTSCHE BANK AG	**Defendant**

- -
- -

Benjamin Strong QC (instructed by **Clyde & Co LLP**) for the **Claimant**
Richard Handyside QC and Rupert Allen (instructed by **Linklaters LLP**) for the **Defendant**

Hearing date: 23 April 2018

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Approved Judgment

I direct that pursuant to CPR PD39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic

MR JUSTICE ROBIN KNOWLES CBE

Mr Justice Robin Knowles:

Introduction

1. Since 14 March 2001 the State of the Netherlands ("the State") and Deutsche Bank AG ("the Bank") have been parties to an agreement using documentation of the International Swap Dealers Association Inc ("ISDA"). The agreement comprises an ISDA Master Agreement (Multicurrency – Cross Border; 1992 version), Schedule and Credit Support Annex (Bilateral Form – Transfer; 1995 version, but with an amendment in 2010 deleting and replacing paragraph 11).

2. Pursuant to the agreement the parties have entered into a number of derivative transactions. Where the State has a net credit exposure to the Bank under these transactions the Credit Support Annex requires the Bank to provide credit support to the State. (As it happens, the Credit Support Annex does not include a requirement for the State to provide credit support to the Bank should there be a net credit exposure of the Bank to the State.)

3. The current position is one of net credit exposure of the State to the Bank and so the requirement for credit support is engaged. For present purposes the material form of credit support is cash collateral provided by the Bank to the State. The Credit Support Annex provides for interest to be paid by the State to the Bank on that cash collateral.

4. However the agreed rate, EONIA minus 0.04%, has been less than zero for the larger part of the time since 13 June 2014. The question in this case is whether the parties' agreement, as made using the ISDA documentation concerned, requires the Bank to pay "negative interest", i.e. interest from the party who provides a principal sum for a period of time, rather than from the party who receives it and has the use of it for a period of time. The agreement predates the ISDA 2014 Collateral Agreement Negative Interest Protocol and was not amended in light of that Protocol.

5. The parties chose English Law to govern their agreement and the English Court to decide any dispute between them. The dispute is classically suitable for the Financial List and that is where the parties have pursued it.

The agreement between the parties

6. Paragraph 10 of the Credit Support Annex provides:

   "***"Eligible Credit Support"*** means, with respect to a party, the items, if any, specified as such for that party in Paragraph 11(b)(ii) including, in relation to any securities, if applicable, the proceeds of any redemption in whole or in part of such securities by the relevant issuer."

In turn, paragraph 11 specifies the items that will qualify as "Eligible Credit Support" for the Bank. These comprise, in summary, cash, certain Government-issued negotiable debt obligations and "such other Eligible Collateral as may be agreed between the parties".

7. Paragraph 5 of the Credit Support Annex is in these terms:

"**Paragraph 5. Transfer of Title, No Security Interest, Distributions and Interest Amount**

(a) ***Transfer of Title.*** Each party agrees that all right, title and interest in and to any Eligible Credit Support, Equivalent Credit Support, Equivalent Distributions or Interest Amount which it transfers to the other party under the terms of this Annex shall vest in the recipient free and clear of any liens, claims, charges or encumbrances or any other interest of the transferring party or of any third person (other than a lien routinely imposed on all securities in a relevant clearance system).

(b) ***No Security Interest.*** Nothing in this Annex is intended to create or does create in favour of either party any mortgage, charge, lien, pledge, encumbrance or other security interest in any cash or other property transferred by one party to the other party under the terms of this Annex.

(c) ***Distributions and Interest Amount.***

(i) ***Distributions.*** [The State] will transfer to [the Bank] not later than the Settlement Day following each Distributions Date cash, securities or other property of the same type, nominal value, description and amount as the relevant Distributions ("Equivalent Distributions") to the extent that a Delivery Amount would not be created or increased by the transfer, as calculated by the Valuation Agent (and the date of calculation will be deemed a Valuation Date for this purpose).

(ii) ***Interest Amount.*** Unless otherwise specified in Paragraph 11(f)(iii), the Transferee will transfer to the Transferor at the times specified in Paragraph 11(f)(ii) the relevant Interest Amount to the extent that a Delivery Amount would not be created or increased by the transfer, as calculated by the Valuation Agent (and the date of calculation will be deemed a Valuation Date for this purpose)."

8. By paragraph 10 of the Credit Support Annex:

"***"Transferee"*** means, in relation to each Valuation Date, the party in respect of which Exposure is a positive number and, in relation to a Credit Support Balance, the party which, subject to this Annex, owes such Credit Support Balance or, as the case may be, the Value of such Credit Support Balance to the other party."

Paragraph 10 went on to provide that "Transferor" meant "in relation to a Transferee, the other party." By paragraph 11 the parties further provided that references to the "Transferee" were to be read as references to the State and

corresponding references to "the Transferor" were to be read as references to the Bank.

9. Paragraph 1 of the Credit Support Annex includes the sentence:

   "For the avoidance of doubt, references to "transfer" in this Annex mean, in relation to cash, payment and, in relation to other assets, delivery."

10. Paragraph 10 of the Credit Support Annex defines "Interest Amount" as follows:

    "***"Interest Amount"*** means, with respect to an Interest Period, the aggregate sum of the Base Currency Equivalents of the amounts of interest determined for each relevant currency and calculated for each day in that Interest Period on the principal amount of the portion of the Credit Support Balance comprised of cash in such currency, determined by the Valuation Agent for each such day as follows:

    (x) the amount of cash in such currency on that day; multiplied by

    (y) the relevant Interest Rate in effect for that day; divided by

    (z) 360 (or, in the case of pounds sterling, 365)."

11. Paragraph 11(f) of the Credit Support Annex provides as follows:

    "(f) **Distributions and Interest Amount**

    (i) ***Interest Rate.*** The "***Interest Rate***" with exception of the condition mentioned hereafter under (iv) will be EONIA minus four (4) basispoints. "EONIA" for any day means the reference rate equal to the overnight rates as calculated on an actual/360 day count by the European Central Bank and appearing on different publication media on the first TARGET Settlement Day following that day. For the purposes of this Annex, TARGET Settlement Day means any day on which the Trans-European Automated Real-Time Gross Settlement Express Transfer (TARGET2) System is open.

    (ii) ***Transfer of Interest Amount.*** The transfer of the Interest Amount will be made on last Local Business Day of each calendar month and on any Local Business Day that a Return Amount consisting wholly or partly of cash is transferred to Party A pursuant to Paragraph 2(b).

    (iii) ***Alternative to Interest Amount.*** The provisions in Paragraph 5(c)(ii) will apply.

    (iv) ***Exception.*** The Interest Rate on cash transferred to an account of Party B other than stated sub (g)(ii) (Dutch National Bank Account number …) will be zero."

12. Paragraph 10 of the Credit Support Annex defines "Credit Support Balance" as follows:

'***"Credit Support Balance"*** means, with respect to a Transferor on a Valuation Date, the aggregate of all Eligible Credit Support that has been transferred to or received by the Transferee under this Annex, together with any Distributions and all proceeds of any such Eligible Credit Support or Distributions, as reduced pursuant to Paragraph 2(b), 3(c)(ii) or 6. Any Equivalent Distributions or Interest Amount (or portion of either) not transferred pursuant to Paragraph 5(c)(i) or (ii) will form part of the Credit Support Balance."

Paragraphs 2 and 10 of the Credit Support Annex also set out related definitions of "Credit Support Amount", "Delivery Amount", "Return Amount". The Master Agreement sets out a definition of "Unpaid Amounts".

Approach to interpretation

13. When interpreting any provision of a commercial contract the court will look at the language and investigate the commercial consequences: see Wood v Capita Insurance Services Ltd [2017] UKSC 24; [2017] AC 1173 at [8]-[15] per Lord Hodge JSC.

14. In the case of an ISDA standard form master agreement "[i]t is axiomatic that it should, as far as possible, be interpreted in a way that serves the objectives of clarity, certainty and predictability, so that the very large number of parties using it should know where they stand": Lomas and others v JFB Firth Rixson Inc and others (ISDA intervening) [2010] EWHC 3372 (Ch); [2011] 2 BCLC 120 at [53] per Briggs J (as he then was) referring to Scandinavian Trading Tanker Co AB v Flota Petrolera Ecuatoriana, The Scaptrade [1983] QB 529 at 540 per Robert Goff LJ (as he then was). There is no sound reason for any different approach in the case of a Credit Support Annex that takes an ISDA standard form.

15. "Although the relevant background, so far as common to transactions of such a varied nature and reasonably expected to be common knowledge among those using the ISDA Master Agreements, is to be taken into account, a standard form is not context-specific and evidence of the particular factual background or matrix has a much more limited, if any, part to play": In Re Lehman Brothers International (Europe) (in administration) (No 8) [2016] EWHC 2417 (Ch); [2017] 2 All ER (Comm) 275 at [48](2) referring to AIB Group (UK) Ltd v Martin [2001] UKHL 63; [2002] 1 WLR 94. Put another way, it is a powerful point of context that the parties chose to use ISDA documentation.

The State's argument

16. If the transfer of negative interest was contemplated by the parties in their agreement, the transfer would be from the Bank to the State. However Paragraph 5(c)(ii) of the Credit Support Annex provides for the State, not the Bank, to transfer Interest Amounts.

17. The State addresses this point by saying that it does not contend that the Bank is obliged to transfer an Interest Amount pursuant to that provision. Instead the State, in an argument presented by Mr Benjamin Strong QC, contends that the Bank is obliged to "account" for negative interest. The mechanism, he argues, is by negative accruals being taken into account in the calculation of other amounts payable between the parties. In particular the State argues that accrued but unpaid interest (including, on its case, negative interest) is included in the calculation of the Credit Support Balance, emphasising the final sentence of the definition of Credit Support Balance.

18. The State contends that the Interest Amount for an Interest Period is produced by summing all positive and negative amounts of daily interest. Where the aggregate of daily accruals over a month has been a negative number it accepts that at the end of such a month there is no interest for the State to pay under paragraph 5(c)(ii), but argues that does not mean that the daily accruals do not exist or should be ignored in calculating the Interest Amount for the Interest Period which will come to an end when interest is next paid, nor that negative daily accruals should not be taken into account in the Credit Support Balance. As interest accrues from day to day the State argues that Credit Support Balance increases by the amount of positive accrued interest and decreases by the amount of negative accrued interest, positive accrued amounts of interest reducing Delivery Amounts (as defined) and increasing Return Amounts (as defined) while negative amounts of accrued interest increase Delivery Amounts and reduce Return Amounts. Mr Strong QC urged in oral and written argument that if some positive daily amounts of interest not required to be transferred (because they are not yet due for payment) are included, negative daily amounts of interest should also be included.

19. The State points out that the commercial purpose of the Credit Support Annex is to ensure that the State has credit protection in the event of termination for default of the transactions entered into under the Master Agreement. That is why paragraph 6 of the Credit Support Annex - a paragraph of particular importance, it was emphasised - provides for an amount equal to the value of the Credit Support Balance to be included as an Unpaid Amount (as defined) in the calculation of the sum due on termination. The State contends that that is also why interest is to be taken into account in the Credit Support Balance.

20. The purpose of the interest provisions, contends the State, like the provision in respect of Distributions, is to bring about a situation in which neither the Transferor nor the Transferee suffers or benefits from the fact that the Transferee holds collateral, over and above the fact that such collateral is to be available in the event of termination for default. Mr Strong QC urged that commercially the aim was equivalence.

Other ISDA materials

21. In his argument for the State, Mr Strong QC sought to rely on ISDA's 2013 Statement of Best Practice for the OTC Derivatives Collateral Process, and ISDA's 2014 Collateral Agreement Negative Interest Protocol.

22. Paragraph 11.2 of the 2013 Statement of Best Practice provided:

"Best Practice 11.2 Negative Interest Rates

Principle

Market participants should review and follow more detailed ISDA guidance that may be published on this topic. In summary, where the floating rate index (eg OIS rates such as Fed Funds, EONIA, SONIA, etc) sets in the market at a negative level, then under the standard published text of the CSA this negative rate should be used in the Interest Rate and Interest Amount calculations. Therefore negative Interest Amounts may be computed. Parties should either settle these negative interest amounts in the reverse direction to normal interest settlement or alternatively compound the negative interest balance into the credit support balance under the CSA, decrementing it rather than incrementing it, as would be the normal case. Where the parties have modified the relevant language within the CSA to change the way that interest is calculated (for example, by the inclusion of a spread, one-way collateral arrangements, and interest rate floor, or other modifying language) the parties should consult and decide how to address negative interest rates."

23. The 2014 Protocol was introduced in order, as described by a Note on Background, that negative benchmark interest rates should:

"… flow through ISDA collateral agreements under certain circumstances so that there is economic consistency between the wholesale funding market (where much collateral is funded), the repo market (where much collateral is sourced or deposited) and the cleared OTC derivative market (where may collateralized trades are hedged)".

The 2014 Protocol contemplated that parties would amend paragraph 5(c) of the Credit Support Agreement in this connection.

24. For its part, the Bank referred to the ISDA User's Guide, which includes the following passage:

"Paragraph 5(c) provides that the Transferee will pass through to the Transferor any distributions of assets or rights it receives in relation to transferred securities and will pay interest on any cash collateral at the rate (which may be zero if the parties do not want to provide for interest), and in accordance with the method, specified in Paragraph 11"

Discussion

25. In my judgment the State's argument does not meet the central point relied on by the Bank, whose argument was presented by Mr Richard Handyside QC and Mr Rupert Allen. To succeed, the State must show that there was an obligation in respect of negative interest but it does not do so.

26. It is true that the definition of "Interest Amount" is capable as a matter of language of allowing for a negative figure. However that is simply a starting point, reached by looking at the definition alone, rather than the agreement as a whole. The question at issue is whether the agreement includes an obligation on the Transferor if the "Interest Amount" is negative. I cannot see that the agreement does include such an obligation. I consider the Bank to be correct in its submission that if there were such an obligation it would be spelled out.

27. There is an obligation at paragraph 5(c)(ii) to transfer (pay) interest, but that is not engaged. The terms of the paragraph envisage payment from the Transferee (here, the State) and not from the Transferor (here, the Bank) as would be the case if negative interest was to be paid. As Mr Handyside QC put it, paragraph 5(c)(ii) "contemplates the transfer of interest by the person holding the collateral to the other person who posted it. It does not require the person who posted the collateral to transfer interest to the person holding it."

28. Moreover the paragraph begins with the words "[u]nless otherwise specified in Paragraph 11(f)(iii)". The parties did not take the opportunity to specify otherwise. Indeed at paragraph 11(f)(iv) they provided for a zero interest rate if the wrong account was used; if negative interest was possible the parties would not have agreed the better outcome (of zero interest) where the wrong account was used.

29. What of the final sentence of the definition of "Credit Support Balance"? As seen, this provides that any "Equivalent Distributions or Interest Amounts (or portion of either) not transferred pursuant to paragraph 5(c)(i) or (ii) will form part of the Credit Support Balance". Does this have the effect of recognising an obligation from the Transferor in respect of negative interest, or does it simply refer to interest that the Transferee is obliged to transfer (pay) under paragraph 5(c)(ii) but has not yet transferred? The provision in paragraph 5(c)(ii) (in the words "to the extent that a Delivery Amount would not be created or increased by the transfer") indicates that there may be interest that the Transferee would otherwise be obliged to transfer (pay) under paragraph 5(c)(ii). That explains well enough the last sentence without requiring a conclusion that it recognises an obligation from the Transferor in respect of negative interest when no such obligation has been spelled out in the agreement.

30. The argument for the State contemplates that while a positive sum by way of interest will be dealt with through the machinery of paragraph 5(c)(ii), a negative sum by way of interest is dealt with through a different machinery. There is no credible commercial rationale for the parties to have made such a choice; if they wanted to deal with negative interest then bringing it into paragraph 5(c)(ii) was the obvious course. Nothing points in the design of the different machinery on which the State relies to that machinery being designed for handling amounts of negative interest.

31. Why should commercial parties have been concerned only with interest where positive and not also where negative? One answer is simply that they accepted there should be simplicity in their arrangements. Another is that the parties intended that where cash collateral could be expected to make money simply by being held, some reflection of that benefit should be received by the Transferor. It does not follow that the parties intended that where cash collateral could be expected to lose money

if simply held, that some reflection of that burden should be shouldered by the Transferor. The former is a price for having the use of the collateral; the latter is a potential cost of the collateral being in cash.

32. Mr Strong QC kindly provided worked examples in the course of his argument but these did not ultimately inform the question of what was agreed. As to the argument that commercially the aim was equivalence, the most that can be said is that the agreement provides what it does in this direction and the results are imperfect. It is worth noting that it is not necessarily the case that the State would incur loss by holding cash where interest rates were negative (ie that the cash collateral would actually diminish): the parties had agreed it remained free to use the cash to earn elsewhere.

33. What of the 2013 Statement of Best Practice and the 2014 Protocol? These were not available to the parties when they made their agreement, and so were not part of their agreement and cannot assist as part of the context of their agreement. Of course they deserve respect, and parties may be encouraged to follow them. However the Statement of Best Practice was not offered by ISDA as a view on interpretation: it expressly provided that "the Best Practices are not intended to create legal obligations nor alter any existing obligations". And the 2014 Protocol envisaged amendment to achieve its ends, including a major amendment to paragraph 5(c)(ii) to address negative interest (and further bilateral discussion where the parties' agreement was for only one party to post collateral).

34. An ISDA User's Guide is, by contrast, available as an aid to interpretation (see Lehman Brothers International (Europe) (in administration) v Lehman Brothers Finance SA [2013] EWCA Civ 188, [2014] 2 BCLC 451 at [52]-[53] per Arden LJ), where relevant background available to the parties when they made their agreement. The passage from the Guide referred to by Mr Handyside QC reinforces the point that the focus of the agreement was on what the Transferee was to do in return for holding cash collateral (just as on what the Transferee was to do in return for holding securities where there were distributions of assets or rights in relation to those securities in the meantime).

Determination

35. In my judgment the State's claim for "negative interest" fails. The standard form ISDA Credit Support Annex (1995 edition, and without amendment including under or in light of the 2014 Collateral Agreement Negative Interest Protocol) does not include an obligation on a Transferor in respect of interest on Eligible Credit Support that is in the form of cash. Put shortly, it does not contemplate a legal obligation to account for negative interest.