Neutral Citation Number: [2019] EWCA Civ 771

Case No: A4/2018/2107

IN THE COURT OF APPEAL (CIVIL DIVISION)
ON APPEAL FROM THE HIGH COURT OF JUSTICE
BUSINESS AND PROPERTY COURTS OF ENGLAND AND WALES
FINANCIAL LIST (Commercial Court - QBD)
The Honourable Mr Justice Robin Knowles CBE
Claim Number FL 2017 000007

Royal Courts of Justice
The Rolls Building
London, EC4A 1NL

Date: 02/05/2019

Before:

SIR GEOFFREY VOS, CHANCELLOR OF THE HIGH COURT
LORD JUSTICE LONGMORE
and
LADY JUSTICE ASPLIN

B E T W E E N:

THE STATE OF THE NETHERLANDS

Claimant / Appellant

-and-

DEUTSCHE BANK AG

Defendant / Respondent

- -

Mr Benjamin Strong QC, (instructed by **Clyde & Co LLP**) appeared for the **Appellant**.

Mr Richard Handyside QC and **Mr Rupert Allen** (instructed by **Linklaters LLP**) appeared for the **Respondent**.

Hearing date: 2nd April 2019

Approved Judgment

Sir Geoffrey Vos, Chancellor of the High Court (delivering the judgment of the Court):

Introduction

1. The simple issue in this case is whether negative interest accrues on cash collateral posted under the Credit Support Annex dated 15th March 2010 (the "CSA"). The CSA is an annex to the International Swaps and Derivatives Association Inc's ("ISDA") Master Agreement (the "Master Agreement"). The State of Netherlands (the "State") originally entered into the Master Agreement with Deutsche Bank (the "Bank") from 14th March 2001 in order to provide the contractual foundation for the State's derivative trading.

2. The standard form CSA provides for "credit support" (collateral) to be provided in appropriate circumstances by both sides to the transaction, but, in this case, a bespoke paragraph 11(h)(i) provided that the terms "Transferor" and "Transferee" should refer only to the Bank and the State respectively. That had the effect that only the Bank was obliged to provide credit support to the State, but not the other way around.

3. Mr Justice Robin Knowles determined that the State's claim for negative interest failed because the CSA did not "include an obligation on a Transferor in respect of interest on Eligible Credit Support that is in the form of cash". Put shortly, he said, that the CSA "does not contemplate a legal obligation to account for negative interest".

4. The appellant State contends that, whilst paragraph 5(c)(ii) of the CSA provides only for the transfer of positive interest from the State (as Transferee of the collateral) to the Bank (as Transferor of the collateral), the provisions of the CSA that relate to the "delivery" and "return" of collateral require that negative interest is accounted for. In essence, the State submits that the defined term "Interest Amount" can include negative interest, and the definition of "Credit Support Balance" requires that that negative interest should "form part of" that Credit Support Balance.

5. The respondent Bank submits that it can be seen from a consideration of the CSA as a whole that those drafting it, and therefore the parties to this dispute, never contemplated or intended that negative interest would be accrued or paid. It accepts that the provisions relating to "Delivery Amounts" and "Return Amounts" supported by the definition of "Credit Support Balance" can be read as allowing for negative interest to be accounted for. But the Bank submits that, if that had been the intention, the CSA would have made clear in paragraph 5(c)(ii) that negative, as well as positive, interest was payable.

6. We will return to these competing positions in due course. It is first necessary to identify the relevant terms of the CSA, the factual background, the judge's reasons, and the competing arguments of the parties.

The terms of the CSA

7. The CSA has to be read in the context of the Master Agreement and in its entirety. Our limited citation of its terms should not, therefore, be taken as an indication that its other provisions are not relevant. Counsel on both sides took the trouble in argument to explain, by reference to the detailed terms of the CSA, the way in which it operates

in practice. That understanding is crucial to the interpretation issue we have to consider.

8. The problem in this case arises because of the low interest rate specified by the parties in the CSA. The rate in question is the Euro Over-Night Interest Average, calculated by the European Central Bank ("EONIA") minus 0.04% (or 4 basis points).

9. The most relevant provisions of the CSA are as follows. It will be recalled, in reading these terms, that (a) the "Transferor" of the collateral was agreed in Paragraph 11(h)(i) always and only to be the Bank, and the "Transferee" was the State, and (b) "Party A" was defined as the Bank, and Party B was defined as the State.

> **Paragraph 1. Interpretation**
> ... For the avoidance of doubt, references to "transfer" in this [CSA] mean, in relation to cash, payment and, in relation to other assets, delivery.
>
> **Paragraph 2. Credit Support Obligations**
>
> (a) ***Delivery Amount***. Subject to Paragraphs 3 and 4, upon a demand made by the Transferee on or promptly following a Valuation Date, if the Delivery Amount for that Valuation Date equals or exceeds the Transferor's Minimum Transfer Amount, then the Transferor will transfer to the Transferee Eligible Credit Support having a value as of the date of transfer at least equal to the applicable Delivery Amount (rounded pursuant to Paragraph 11(b)(iii)(D)). Unless otherwise specified by Paragraph 11(b), the "Delivery Amount" applicable to the Transferor for any Valuation Date will equal the amount by which:
>
> (i) the Credit Support Amount
>
> exceeds
>
> (ii) the Value as of that Valuation Date of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and to exclude any prior Return Amount, the transfer of which, in either case, has not yet been completed and for which the relevant Settlement Day falls on or after such Valuation Date).
>
> (b) ***Return Amount***. Subject to Paragraphs 3 and 4, upon a demand made by the Transferor on or promptly following a Valuation Date, if the Return Amount for that Valuation Date equals or exceeds the Transferee's Minimum Transfer Amount, then the Transferee will transfer to the Transferor Equivalent Credit Support specified by the Transferor in that demand having a Value as of the date of transfer as close as practicable to the applicable Return Amount (rounded pursuant to Paragraph 11(b)(iii)(D)) and the Credit Support Balance will, upon such transfer, be reduced accordingly. Unless otherwise specified in Paragraph 11(b), the "Return Amount" applicable to the Transferee for any Valuation Date will equal the amount by which:
>
> (i) the Value as of that Valuation Date of the Transferor's Credit Support Balance (adjusted to include any prior Delivery Amount and

to exclude any prior Return Amount, the transfer or which, in either case, has not yet been completed and for which the relevant Settlement Day falls on or after such a Valuation Date)

exceeds

(ii) the Credit Support Amount.

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 [CSA] 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 [CSA] 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 [CSA].

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

(i) ***Distributions***. The Transferee will transfer to the Transferor 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).

Paragraph 6. Default

If an Early Termination Date is designated or deemed to occur as a result of an Event of Default in relation to a party, an amount equal to the Value of the Credit Support Balance, determined as though the Early Termination Date were a Valuation Date, will be deemed to be an Unpaid Amount due to the Transferor (which may or may not be the Defaulting Party) for purposes of Section 6(e). For the avoidance of doubt, if Market Quotation is the applicable payment measure for purposes of Section 6(e), then the Market Quotation determined under Section

6(e) in relation to the Transaction constituted by this Annex will be deemed to be zero, and, if Loss is the applicable payment measure for purposes of Section 6(e), then the Loss determined under Section 6(e) in relation to the Transaction will be limited to the Unpaid Amount representing the Value of the Credit Support Balance.

Paragraph 9. Miscellaneous

(a) **Default Interest**. Other than in the case of an amount which is the subject of a dispute under Paragraph 4(a), if a Transferee fails to make, when due, any transfer of Equivalent Credit Support, Equivalent Distributions or the Interest Amount, it will be obliged to pay the Transferor (to the extent permitted under applicable law) an amount equal to interest at the Default Rate multiplied by the Value on the relevant Valuation Date of the items of property that were required to be transferred, from (and including) the date that the Equivalent Credit Support, Equivalent Distributions or Interest Amount were required to be transferred to (but excluding) the date of transfer of the Equivalent Credit Support, Equivalent Distributions or Interest Amount. This interest will be calculated on the basis of daily compounding and the actual number of days elapsed.

Paragraph 10. Definitions

"*Credit Support Amount*" means with respect to a Transferor on a Valuation Date (i) the Transferee's Exposure plus (ii) all Independent Amounts applicable to a Transferee if any, minus, (iv) the Transferor's Threshold; provided, however, that the Credit Support Amount will be deemed to be zero whenever the calculation of Credit Support Amount yields a number less than zero.

"*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 [CSA], 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.

"*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.

"*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).

"*Interest Period*" means the period from (and including) the last Local Business Day on which an Interest Amount was transferred (or, if no Interest Amount has yet been transferred, the Local Business Day on which Eligible Credit Support or Equivalent Credit Support in the form of cash was transferred to or received by the Transferee) to (but excluding) the Local Business Day on which the current Interest Amount is transferred.

"***Minimum Transfer Amount***" means with respect to a party, the amount specified as such for that party in Paragraph 11(b)(iii)(C); if no amount is specified, zero.

"*Threshold*" means with respect to a party, the Base Currency Equivalent of the amount specified as such for that party in Paragraph 11(b)(iii)(B); if no amount is specified, zero.

"*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.

"*Transferor*" means in relation to a Transferee, the other party.

Paragraph 11. Elections and Variables

(b) **Credit Support Obligations**

(iii) ***Thresholds***

(A)

"***Independent Amount***" means:
with respect to Party A:

- if at least 2 out of 3 rating Agencies stated in Paragraph 11 (b)(iii)(E) have rated (in conformity of Paragraph 11 (b)(iii)(E)) Party A below or revised downward below either AA- in the case of S&P / Fitch IBCA or Aa3 in the case of Moody's or their respective equivalent ratings issued by a Substitute Agency: one percent (1 %) of the notional amount of the Swap portfolio on the Valuation Date with regard to swaps concluded as from the moment this condition will come into effect for the first time after the date of such downgrade. The overall maximum Independent Amount is set on 75 million euro;

- in other circumstances: None; and

with respect to party B: None.

(B) "***Threshold***" means the amount determined on the basis of the ratings assigned to Party A

(C) "***Minimum Transfer Amount***" means with respect to Party A and Party B: The amount equivalent to 1 million euro.

(D) "***Rounding***". The Delivery Amount and the Return Amount will be rounded up or down to the nearest integral multiple of 1000 euro.

(c) **Valuation and Timing**

(i) "**Valuation Agent**" means, for the purposes of Paragraphs 2 and 4, the party making the demand under Paragraph 2, and, for the purposes of Paragraph 5(c): Party A.
The valuation of the Credit Support Amount shall be made pursuant to Paragraph 3(b) and pursuant to the following procedures:

Party A shall before the Notification Time report by email to Party B:

(a) The market value of each collateralised transaction, denominated in euro.

(b) The market value of the posted collateral to Party B, denominated in euro.

(c) The Credit Support Amount, denominated in euro.

(d) The valuation curve used.

(ii) "**Valuation Date**" means each Local Business Day.

(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) basis points. "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 [CSA], 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.

Factual background

10. In March 2001, the State, acting through the Dutch State Treasury Agency, entered into the Master Agreement and the then current version of the CSA with the Bank.

11. The "User's Guide to the ISDA Credit Support Documents under English Law" had been published in 1999 (the "User's Guide"). It was, therefore, accepted as being admissible factual matrix in relation to the interpretation of the CSA. It drew attention to the distinction between the CSA and the Credit Support Deed, which in contrast to the CSA, created a security interest in collateral transferred under it. Paragraph I.C.6. of the User's Guide, which explained the CSA's "Structure, Form and Key Provisions" said as follows under the heading "Distributions and Interest Amount": "[p]aragraph 5(c) [of the CSA] 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 [of the CSA concerning "Elections and Variables"]". Paragraphs II.C.2, II.C.3, II.C.4 and II.C.8 explained elements of the paragraph 11 variables, including the important defined terms, the thresholds and the "Distributions and Interest Amount". Mr Richard Handyside QC, leading counsel for the Bank, drew attention to the fact that these passages, indeed the User's Guide as a whole, made no reference to negative interest.

12. On 15th March 2010, the parties agreed to amend the CSA to the form that is currently in issue.

13. On 30th June 2010, ISDA issued a statement of "Best Practices for the OTC Derivatives Collateral Process". Best Practice 11.2 headed "Flooring of Interest Rates" provided for the "Principle" that "[a]t no point should the interest accrual (rate minus spread) drop into a negative figure. If this occurs the rate should be floored at zero". The "Description" then explained that:-

> "[m]any CSA agreements were written and agreed when it was not anticipated that interest rates would reach extremely low levels. However market conditions have occurred where the interest accrual formula could result in a negative number with a collateral provider obligated to pay interest to a collateral holder. At no point should the interest accrual (rate minus spread) drop into a negative figure. If this occurs then the best practice is to floor the interest rate at zero".

14. On 30th November 2011, ISDA issued a further statement of "Best Practices for the OTC Derivatives Collateral Process". Best Practice 11.2 again headed "Flooring of Interest Rates" had been amended so that the "Principle" provided that:-

> "[i]n the circumstance where market conditions cause the interest accrual (rate minus spread) to drop to a negative figure and the CSA is not explicit on

> the flooring of interest rates, parties should bilaterally agree interest accrual handling".
>
> The "Description" included the same first two sentences as in June 2010, but replaced the final sentence with the statement that:
>
> > "[p]arties should always follow the interest accrual rate defined in the CSA, however, in the circumstance where an existing CSA is not explicit regarding the flooring of interest rates, parties should bilaterally agree the handling of interest accruals should market conditions cause the rate to drop to a negative figure"".

15. On 23rd October 2013, ISDA issued a further statement of "Best Practices for the OTC Derivatives Collateral Process". Best Practice 11.2 was headed "Negative Interest rates". It provided that the "Principle" was that:-

> "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 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, an interest rate floor, or other modifying language) the parties should consult and decide how to address negative interest rates".

16. On 13th June 2014, the Interest Rate fell below zero for the first time in recent years.

17. On 12th May 2014, ISDA published a "Collateral Agreement Negative Interest Protocol" (the "2014 Protocol") which enabled parties to a CSA (like the one in issue in this case) to amend its terms to provide for the payment of negative interest. Mr Handyside pointed out that the 2014 Protocol made root and branch changes to paragraph 5(c)(ii) of the CSA in order to achieve its objective. The details are not relevant to what we have to decide. It was, however, common ground that the parties here did not make the amendments provided for by the 2014 Protocol.

18. The parties also referred in detail to the note on the "Background" to the 2014 Protocol that was published by ISDA alongside it on 12th May 2014. The Background note explained that the 2014 Protocol had been developed to address the concerns of ISDA members that "if negative interest rates were to set in OIS benchmarks used as the Interest rate for cash collateral it may be unclear how such negative rates should be treated under ISDA collateral documentation". The Background note also said that a Study Group composed of derivative dealers and end users had thought that "[f]rom a commercial perspective … it was important and desirable that negative benchmark OIS 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 many collateralized trades are hedged)". The Background note concluded by recording that the Study Group believed that the issue of negative interest rates remained an "important and timely issue to resolve".

19. On 24th August 2017, the State issued a Claim Form against the Bank seeking the following declarations in respect of the CSA:-

> "(i) On any day when the Interest Rate is a negative number, interest is to be determined in accordance with the definition of "Interest Amount" and the portion of the Interest Amount for the Interest Period in which that day falls is a negative number.
>
> (ii) On any Valuation Date:
>
> any portion of an Interest Amount (including in respect of an Interest Period not yet ended) which has not been transferred to [the Bank] forms part of [the Bank's] Credit Support Balance;
>
> any such portion which is positive is added to the Credit Support Balance; and
>
> any such portion which is negative is deducted from the Credit Support Balance.
>
> (iii) Accrued positive interest which has not been transferred by the Transferor (whether due or not) has the effect of decreasing any Delivery Amount and increasing any Return Amount;
>
> (iv) Accrued negative interest (if not paid by [the Bank]) has the effect of increasing any Delivery Amount and decreasing any Return Amount.
>
> (v) The [State] is entitled to have the Credit Support Balance, any Delivery Amount and any Return Amount calculated in accordance with the foregoing".

20. On 30th November 2017, the parties agreed the issues for determination at trial as follows:-

> "on the true construction of the [CSA]: … How and in what circumstances is an Interest Amount (or a portion of an Interest Amount) to be taken into account in the calculation of the Credit Support Balance? In particular (a) How is an Interest Amount to be calculated if the Interest Rate is negative on one or more days during the relevant Interest Period? (b) Can an Interest Amount (or portion of an Interest Amount) be negative? (c) If so, is a negative Interest Amount (or a negative portion of an Interest Amount) to be taken into account in reduction of the Credit Support Balance?"

21. After a one-day trial without oral evidence on 23rd April 2018, the judge delivered his judgment on 25th July 2018 in terms described in detail below. His order dated 26th July 2018 dismissed the State's claim and refused it permission to appeal.

22. On 31st August 2018, the State's ground of appeal included in its Appellant's Notice contended that:-

> "[the judge had] erred in finding that the [CSA] agreed by the parties does not contemplate a legal obligation to account for negative interest. He should have found that, on any day when the Interest Rate is a negative number, interest is to be determined at that rate in accordance with the definition of Interest Amount, and the portion of the Interest Amount for the Interest Period in which that day falls is a negative number and is to [be] taken into account in the Credit Support Balance, including for the purposes of determining Delivery Amounts and any Return Amounts".

23. On 27th September 2018, Asplin LJ granted the State's application for permission to appeal.

The judgment

24. After setting out some background and parts of the CSA, the judge dealt with his approach to interpretation at paragraphs 13-15.

25. The judge then summarised the State's argument and the ISDA materials on which the parties relied. In this context, he said at paragraph 23 that "[t]he 2014 Protocol contemplated that parties would amend paragraph 5(c) of the Credit Support Agreement in this connection [i.e. to provide for negative interest rates]".

26. The judge began his discussion by explaining that the State's argument failed because it did not meet the Bank's central point that, in order to succeed, it had to show that there was an obligation in respect of negative interest.

27. The judge then acknowledged that the definition of "Interest Amount" was capable as a matter of language of allowing for a negative figure. The question at issue was, however, whether the CSA included an obligation on the Transferor if the "Interest Amount" were negative. Looking at the CSA as a whole, he held that the CSA did not include such an obligation. He considered that the Bank was right to submit that "if there were such an obligation it would be spelled out".

28. In paragraphs 27 and 28, the judge considered paragraph 5(c)(ii) of the CSA, holding that it was not engaged, because payment was only envisaged from the State as Transferee to the Bank as Transferor. The proviso at the start of paragraph 5(c)(ii) "[u]nless otherwise specified in Paragraph 11(f)(iii)" highlighted that the parties had not taken the opportunity to specify that negative interest was payable. Instead at paragraph 11(f)(iv), they had provided for a zero interest rate if the wrong account were used: "if negative interest was possible the parties would not have agreed the better outcome (of zero interest)" in that situation.

29. The judge rejected the submission that the definition of "Credit Support Balance" pointed to a different conclusion as follows:-

> "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 judge then characterised the State's argument as contemplating 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". He said there was "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". He concluded that nothing pointed to the "different machinery" being "designed for handling amounts of negative interest".

31. At paragraph 31, the judge commented that commercial parties might have been concerned only with positive interest in order to provide simplicity in their arrangements, or to reflect the parties' intention that some benefit should be received by the Transferor where cash collateral could be expected to make money simply by being held. The reverse position did not follow where cash collateral could be expected to lose money: "[t]he former is a price for having the use of the collateral; the latter is a potential cost of the collateral being in cash".

32. The judge was not persuaded by the State's worked examples as they "did not ultimately inform the question of what was agreed", nor did he think that the 2014 Protocol and the 2013 Statement of Best Practice were available context since they "were not available to the parties when they made their agreement". Conversely, the User's Guide was available as an aid to construction, and the passage at paragraph I.C.6. reinforced "the point that the focus of the agreement was on what the Transferee was to do in return for holding cash collateral".

33. The judge concluded that that the CSA did not contemplate a legal obligation to account for negative interest.

The State's submissions

34. Mr Benjamin Strong QC, counsel for the State, submitted that the State's interpretation flowed from the overall architecture of the CSA, that it was supported by how the CSA operated in practice, and was also consistent with the wider commercial context. One should start from the proposition that the language of the ISDA agreements is carefully drafted and is unlikely to have been used by mistake.

35. Paragraph 6 of the CSA is important, because it provides that, on early termination or default, the Credit Support Balance (i.e. the collateral) becomes an Unpaid Amount due to the Bank. The Interest Amount (whether positive or negative) is then an adjustment to that amount under the last sentence of the definition.

36. Mr Strong submitted that, as the User's Guide explains, paragraph 2(a) defines the Delivery Amount as being the amount of top-up collateral required to bring the Credit Support Balance up to the Credit Support Amount required. The Return Amount is the reverse. The Minimum Transfer Amount was agreed in paragraph 11(b)(iii)(C) to be €1 million (except on default), with the figures rounded to the nearest €1,000. The Exposure is tested on every Local Business Day, because of the definition of Valuation Date. The definition of Credit Support Amount then provides the calculation that must be undertaken to decide whether a Delivery Amount or Return Amount is payable. That is, in effect, the State's Exposure plus or minus all "Independent Amounts" (which are irrelevant for this purpose) less the Threshold, which varies between €0 and €65 million depending on the credit rating of the Bank. It was, in fact, generally €65 million. The Credit Support Amount may, therefore, be negative, if the State's Exposure is less than the €65 million threshold, but the definition of Credit Support Amount defines a negative amount as zero, which is why the State as collateral holder cannot be forced to pay back more than it holds.

37. The definition of Credit Support Balance then includes everything transferred to the State less anything transferred back, but it also includes any outstanding Interest Amount (as defined). This works whether the collateral is cash or securities. The definition of Interest Amount admits of either positive or negative amounts and paragraph 11(f)(ii) says that it is to be paid monthly or when collateral is being returned. Paragraphs 11(f)(i) and (iv) fix the Interest Rate at EONIA minus 4 basis points, but at zero if the Bank pays the cash collateral to the wrong account. Mr Strong argued that the CSA provides expressly where amounts are to be replaced by zero – paragraphs 11(f)(iv) and the definition of Credit Support Amount being examples. The definition of Interest Amount could, therefore, have been expected to say so if negative interest were to be treated as zero as the Bank submits. Instead, the Interest Amount is defined as a daily mathematical formula, providing for the aggregate of daily accruals to be calculated. The fact that paragraph 5(c)(ii) does not create an obligation to transfer a negative amount, submitted Mr Strong, has no impact on the accrual process provided for by the paragraphs mentioned. Moreover, the definition of Interest Period fits in with this process, because, on any one day, one will not know when the Interest Period is due to end. The Interest Period does not come to an end if nothing positive is payable, but only ends when a positive amount is payable and paid. Commercially, therefore, negative interest is only accounted for when there is a Return Amount or a Delivery Amount payable. The fact that negative interest is not paid under paragraph 5(c)(ii) does not mean it does not have to be accounted for.

38. The Judge was, according to Mr Strong, wrong to frame the issue as turning on whether there was a free-standing obligation to pay negative interest. A running total must be kept under the CSA. If the interest total is negative, there nothing to transfer under paragraph 5(c)(ii), until the interest rate has become positive and there is a positive balance at the end of the month. The two mechanisms work together well, and the definition of Credit Support Balance ensures that positive and negative interest is taken account of on termination.

39. Mr Strong produced a very clear demonstration of how the system works on the State's interpretation using indicative figures in a spreadsheet. Taking the Minimum Transfer Amount of €1 million and the rounding amount of €1,000, the reality was

that Interest Payments were made on occasions when the rate was positive, but not when the rate was negative. The spreadsheets showed how the State's interpretation would work in practice in positive and negative interest environments. Mr Handyside accepted that the figures were accurate in themselves, but argued that negative interest could not be accrued so that the interest figures in the negative interest environment should always be zero.

40. Mr Strong noted that, if the Minimum Transfer Amount had been zero (rather than €1 million), payment would be dealt with exclusively by the Delivery and Return Amounts. The judge had oversimplified the State's argument in the first sentence of paragraph 30, when he suggested that it contemplated that a positive interest sum was dealt with under paragraph 5(c)(ii), and negative sums by another machinery. Mr Strong submitted that the Bank's argument just ignored negative interest when there was no provision saying it should be ignored, and no good commercial reason to ignore it.

41. Mr Strong submitted that the later ISDA documentation supported his case. He pointed out that the Master Agreement provided for negative numbers in several places, including, for example, the definition of "Market Quotation". The Judge's suggestion that, if the State were right, the Bank would be better off in a negative interest environment by paying collateral into the wrong account, failed to take account of default interest provisions.

42. Finally, in relation to the commercial purpose of the CSA, Mr Strong argued that the CSA was to provide credit protection, not to enable the collateral receiver to make money; that was why both positive interest and distributions had to be passed on.

The Bank's submissions

43. The Bank submitted that the sole interest obligation was in paragraph 5(c)(ii) of the CSA. That provision simply did not require payment of negative interest. If negative interest had been intended, it would have said so in paragraph 5(c)(ii). The parties confirmed, rather than amended, paragraph 5(c)(ii) at paragraph 11(f)(ii). The examples provided by the State prove nothing because there are so many variables under the CSA. The State's interpretation simply produces anomalies. There is no credible reason why negative interest would have been dealt with otherwise than in paragraph 5(c)(ii).

44. Mr Handyside submitted that the process of interpretation was aimed at ascertaining the objective meaning of the language. It was not a literalist exercise focusing on a single definition. The court should engage in a unitary process checking the supposed interpretation against the agreement as a whole.

45. The two-way payments envisaged in paragraph 2 of the CSA are to be contrasted with the one-way payment of interest envisaged by paragraph 5(c)(ii). That is why the zero deeming provision was needed in the definition of Credit Support Amount.

46. In relation to the final sentence of the definition of Credit Support Balance, Mr Handyside submitted that an "Interest Amount" had to be a positive amount transferable by the State to the Bank. As a matter of language, the words "not transferred" meant "transferable but not yet transferred under paragraph 5(c)(ii)".

Asplin LJ suggested to Mr Handyside that, if Mr Strong were right, that last sentence ought to say "not transferable", rather than "not transferred". The Chancellor commented in response that, if the sentence had referred to an "Interest Amount not transferable pursuant to paragraph 5(c)(ii)", that would not achieve its purpose because even a positive Interest Amount is not transferable under paragraph 5(c)(ii) if it creates or increases a Delivery Amount. Mr Handyside submitted that the whole purpose of the words "not transferred pursuant to Paragraph 5(c)(ii)" was to make clear that the qualification in the last sentence of the definition of Credit Support Balance was only referring to an Interest Amount that fell within paragraph 5(c)(ii). He also suggested that the words "form part of" were not apt to include a negative Interest Amount, and that only positive distributions were covered by paragraph 5(c)(i), which indicated that the same should be the case under paragraph 5(c)(ii).

47. Mr Handyside pointed to 5 asymmetries created by the State's interpretation: (i) paragraph 5(c)(ii) covers positive, but not negative, interest, (ii) the trigger for payment of negative interest is a Delivery or Return Amount, but that represents a shift in the value of the underlying portfolio, which may never happen, (iii) under the Delivery Amount provisions, there is a Minimum Payment Amount of €1 million, whereas paragraph 5(c)(ii) requires every amount to be paid, (iv) all amounts, other than Interest Amounts, are rounded under the CSA, so that would be a disparity between accounting for positive and negative interest, and (v) under paragraph 11(f)(iv), any transfer to the wrong account reduces interest to zero, but the logic of the State's position would be that it should receive the lower of zero or a negative rate.

48. The Bank also relied on the User's Guide as supporting its case, pointing to the fact that there was no mention of negative interest, as one would have expected if the State were right, at paragraphs I.C.6 and II.C.8. The Best Practice Documents and the 2014 Protocol documents were not admissible as factual matrix as post-dating the CSA. Finally, Mr Handyside submitted that the State had no support from the commercial context; the CSA did not provide perfect credit protection to the State.

Authorities on interpretation

49. The parties referred to only two authorities on interpretation. It is worth citing them both relatively briefly. Hildyard J in *Re Lehman Brothers (No 8)* [2016] EWHC 2417 (Ch) [2017] 2 All ER (Comm) 275 ("*Lehmans*") said the following at paragraph 48 in relation to the interpretation of ISDA Master Agreements:-

> "In the context of the ISDA Master Agreements, and having regard to their intended and actual use as standard agreements by parties with such different characteristics in a multiplicity of transactions in a plethora of circumstances, the following principles are also relevant:
>
> (1) It is "axiomatic" that the ISDA Master Agreements should, "as far as possible be interpreted in a way that achieves the objectives of clarity, certainty and predictability, so that the very large number of parties using it know where they stand": *Lomas v JFB Firth Rixson* [2010] EWHC3372 (Ch.) at [53] *per* Briggs J.

> (2) Although the relevant background, so far as common to transactions of such a varied nature and reasonably expected to be common knowledge amongst 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: see *AIB Group (UK) Ltd v Martin* [2002] 1 WLR 94.
>
> (3) More than ever, the focus is ultimately on the words used, which should be taken to have been selected after considerable thought and with the benefit of the input and continuing review of users of the standard forms and of knowledge of the market: see *The Joint Administrators of Lehman Brothers International (Europe) v Lehman Brothers Finance* [2013] EWCA Civ 188 at [53] and [88].
>
> (4) The drafting of the ISDA Master Agreements is aimed at ensuring, among other things, that they are sufficiently flexible to operate among a range of users in an infinitely variable combination of different circumstances: *Anthracite Rated Investments (Jersey) Limited v Lehman Brothers Finance S.A* [2007] EWHC 1822 (Ch) *per* Briggs J (at [115]): particular care is necessary not to adopt a restrictive or narrow construction which might make the form inflexible and inappropriate for parties who might commonly be expected to use it".

50. In *Wood v. Capita Insurance Services Limited* [2017] 2 WLR 1095 ("*Wood v. Capita*"), Lord Hodge JSC explained the latest authorities as follows at paragraphs 10-14:-

> "10. The court's task is to ascertain the objective meaning of the language which the parties have chosen to express their agreement. It has long been accepted that this is not a literalist exercise focused solely on a parsing of the wording of the particular clause but that the court must consider the contract as a whole and, depending on the nature, formality and quality of drafting of the contract, give more or less weight to elements of the wider context in reaching its view as to that objective meaning. …
>
> 11. … Interpretation is, as Lord Clarke JSC stated in the *Rainy Sky* case [[2011] 1 WLR 2900] (para 21), a unitary exercise; where there are rival meanings, the court can give weight to the implications of rival constructions by reaching a view as to which construction is more consistent with business common sense. But, in striking a balance between the indications given by the language and the implications of the competing constructions the court must consider the quality of drafting of the clause …
>
> 12. This unitary exercise involves an iterative process by which each suggested interpretation is checked against the provisions of the contract and its commercial consequences are investigated: the *Arnold* case[[2015 UKSC 36], para 77 citing *In re Sigma Finance Corpn [2010] 1 All ER 571* , para 12, per Lord Mance JSC. …
>
> 13. Textualism and contextualism are not conflicting paradigms in a battle for exclusive occupation of the field of contractual interpretation. Rather, the

> lawyer and the judge, when interpreting any contract, can use them as tools to ascertain the objective meaning of the language which the parties have chosen to express their agreement. …".

51. We would also mention one of Lord Neuberger's seven points in *Arnold v. Britton*, since it has some significance to the present situation:-

> "22. Sixthly, in some cases, an event subsequently occurs which was plainly not intended or contemplated by the parties, judging from the language of their contract. In such a case, if it is clear what the parties would have intended, the court will give effect to that intention. An example of such a case is Aberdeen City Council v Stewart Milne Group Ltd [2011] UKSC 56, 2012 SCLR 114, where the court concluded that "any … approach" other than that which was adopted "would defeat the parties' clear objectives", but the conclusion was based on what the parties "had in mind when they entered into" the contract (see paras 17 and 22)".

Discussion

52. Two starkly contrasting interpretations of the CSA are advanced. We have thought carefully about these interpretations and can accept that each is an available meaning of the words used. It is notable that each side is able to include in its argument the forensic point that the draftsman could have said specifically what the other contends for, had it been intended. The Bank says that paragraph 5(c)(ii) would have said so, if negative interest were to be included; and the State says that the definition of Interest Amount would have said so if negative interest were to be treated as zero as the Bank submits.

53. In the circumstances, the passage from Hildyard J's judgment in *Lehmans* on which the State particularly relied does not take the matter much further. Hildyard J was undoubtedly right to say, in an ISDA context, that the focus should be on the words used "which should be taken to have been selected after considerable thought and with the benefit of the input and continuing review of users of the standard forms and of knowledge of the market". We are here, however, more in the territory of paragraph 10 of Lord Hodge's judgment in *Wood v. Capita*, emphasising the need to consider the contract as a whole, and paragraph 11, where he said that:-

    i) interpretation was a unitary exercise, so that "where there are rival meanings, the court can give weight to the implications of rival constructions by reaching a view as to which construction is more consistent with business common sense", and

    ii) "in striking a balance between the indications given by the language and the implications of the competing constructions the court must consider the quality of drafting of the clause".

54. With that introduction, we can start by considering the judge's decision. We agree with the State that he adopted too simplistic an approach. The main reason for the judge's conclusion, expressed more than once, was that the CSA did not include an obligation in paragraph 5(c)(ii) or elsewhere to pay negative interest. But, in our judgment, the judge did not give sufficient reasons for rejecting the importance of the

last sentence of the definition of "Credit Support Balance" which provided that any "Interest Amounts … not transferred pursuant to Paragraph 5(c) … (ii) will form part of the Credit Support Balance". We do not accept that it is adequately explained by the proviso in paragraph 5(c)(ii) abrogating the requirement to make an interest payment where "a Delivery Amount would … be created or increased by the transfer". It is true that there **will** be circumstances where an Interest Amount will not become transferable under paragraph 5(c)(ii) because of that proviso. But the State's point was that (a) the definition of Interest Amount allowed for the possibility of a negative Interest Amount, (b) such negative interest could be recognised as "form[ing] part" of the Credit Support Balance in accordance with the last sentence of the definition, and (c) such a negative Interest Amount would not have been "transferred pursuant to Paragraph 5(c) … (ii)".

55. Moreover, in our judgment, the judge misstated the State's argument at paragraph 30 of his judgment, where he said that it contemplated that a positive interest sum was dealt with under paragraph 5(c)(ii), and negative sums by a different machinery. The argument was that the machinery of making interest part of the Credit Support Balance applied as much to positive interest as to negative interest.

56. This is a case, in our judgment, where some assistance can be gained from the factual matrix, available to parties seeking to use the ISDA forms, in 2001 and 2010. It is significant that the User's Guide published in 1999 makes no reference to negative interest being provided for. That is not particularly surprising, bearing in mind the prevailing interest rates at that time, but negative interest rates were a possibility even in 1999, particularly when the Interest Rate specified under the CSA is EONIA **minus** 4 basis points. Whilst it would not normally be possible to look at post-contractual documentation as being indicative of factual matrix, here the Best Practice statement issued just after the CSA was amended in 2010 stated that "[a]t no point should the interest accrual (rate minus spread) drop into a negative figure. If this occurs the rate should be floored at zero". And the "Description" is also informative as to the thinking when the CSA was drafted when it stated that "[m]any CSA agreements were written and agreed when it was not anticipated that interest rates would reach extremely low levels", and even though market conditions had occurred "where the interest accrual formula could result in a negative number" the interest accrual rate should not be negative. We acknowledge that this document was not placed before the trial judge, but it is and was always publicly available after June 2010. It has some significance in that it shows ISDA's thinking at or around the time of the CSA.

57. By the time of the Best Practice statement of 30th November 2011, ISDA had softened its position to one suggesting bilateral agreement of "the handling of interest accruals should market conditions cause the rate to drop to a negative figure". And it was not until the 23rd October 2013 that ISDA's Best Practice statement suggested that market participants should review and follow more detailed (future) guidance in relation to negative rates. By May 2014, negative rates had become a reality and ISDA had drafted a wholesale revision to the CSA for market participants to agree if they chose to do so. ISDA, at no stage, suggested prior to the 2010 amendment to the CSA that it was competent or intended to provide for the payment of negative Interest Amounts.

58. We fully accept that these documents cannot in themselves be conclusive, particularly as the most informative of them post-dates the CSA. But we do not think, either, that they can be ignored. When one looks at the language of the carefully drafted CSA,

one has to bear in mind at least that the User's Guide did not alert participants signing up to it that negative Interest Amounts were to be accounted for as part of the Credit Support Balance.

59. Whilst we fully understand the power of the forensic arguments on both sides to the effect that the draftsman could have made the matter clear had he chosen to do so, we think it is more important to look carefully at what the drafting did include, rather than what it did not.

60. In relation to the final sentence of the definition of Credit Support Balance, we take the clear view that the words used could, in theory, bear the meaning that the State ascribes to them. Moreover, we are not sure that it is necessary to read the words "not transferred" as meaning "transferable but not yet transferred under paragraph 5(c)(ii)". It seems to us that the real question is whether it can properly be said that the payment of negative interest was contemplated by the CSA considered as a whole. The last sentence of the definition of Credit Support Balance works perfectly well if what is being accounted for as part of that Balance is only positive interest. The definition is just intended to make sure, as Mr Strong's worked examples showed, that an Interest Amount that is not actually transferred under paragraph 5(c)(ii), will be picked up when there is next a Delivery Amount or Return Amount payable.

61. In our judgment, there are a number of reasons why the Bank was right to submit that the CSA cannot be taken to have been referring to negative interest. First, as we have said, the User's Guide and background materials do not show that ISDA thought that negative interest was intended to be payable. Secondly, as is common ground, paragraph 5(c)(ii) covers positive, but not negative, interest. That paragraph is certainly the most obvious place to find a reference to negative interest if it were intended. The fact that it is actually excluded from paragraph 5(c)(ii) is a powerful indicator that it was not contemplated as payable. Thirdly, two of Mr Handyside's asymmetries seem to us to have force. The fact that Interest Amounts are excluded from both the Minimum Payment Amount of €1 million and the rounding provisions creates an inexplicable disparity between the way in which positive and negative interest would be accounted for. Fourthly, Mr Handyside's fifth asymmetry is also a pointer against the State's interpretation, because one would have expected, if the parties had negative interest in mind, that they would have provided in paragraph 11(f)(iv) for transfers to the wrong account to be penalised by reduction of interest to the lower of zero or a negative rate. It is no answer to say that default interest might be payable, because the provision must have a free-standing effect.

62. Our fifth reason is more general and overarching. Despite Mr Strong's ingenious interpretation, we see nothing in the CSA read as a whole that gives the impression that negative interest was contemplated or intended. This may be a situation of the kind envisaged by Lord Neuberger in *Arnold v. Britton supra* where an event subsequently occurs which was plainly not intended or contemplated by the parties – or in this case the market - judging from the language of their contract. We accept that the commercial background can be argued both ways, but the structure of the CSA focuses on Valuation Dates and Delivery and Return Amounts intended to sustain the State's collateral at an agreed level. Interest would, of course, be swept up on a default, but that does not mean that negative interest, which might (as turned out to be the case) be theoretically payable for years, would be likely, if intended to be payable at all, to be excluded from paragraph 5 that deals with Interest Amounts.

Excluding negative interest is not unfair as the State suggests as ISDA's initial reaction to the onset of negative rates demonstrated. It is just a function of what was actually agreed and not agreed.

Conclusion

63. Though we have expressed our reasoning relatively shortly, we have been careful to undertake the process of iterative checking and re-checking of the competing interpretations against each part of the CSA. We can only say that we do not think that, on its true interpretation, applying the approach required by the authorities we have mentioned, the CSA can be taken as providing for the payment of negative, as opposed to positive, interest.

64. We will, therefore, dismiss the appeal.