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Author Ognjen Miletic

Unwinding funding transactions: what you don't know might hurt you

KEY POINTS

- A lender can hedge the interest rate risk associated with fixed rate loans using an internal swap, a "Back-to-Back Swap" and a "Portfolio Hedge" – although the "Back-to-Back Swap" is clearly more specific to the loan than the "Portfolio Hedge".
- If the relevant factual matrix does not include awareness on the part of the borrower of the potential funding arrangements, the question will likely be whether the terms of the loan agreement are sufficiently clear to encompass the interest rate swap transaction in question.
- Notice to the borrower becomes a far more important aspect of the relevant factual matrix if you have a weaker argument on contractual construction.

In this article, Ognjen Miletic tackles the following questions arising from *Barnett & Ors v RBS* [2015] EWHC 2435 (Ch): if an interest rate swap is linked to *external* hedging with a third party, such that there is loss to the lender on early redemption, would the borrowers be liable to pay the termination cost? And what if the existence of the swap is not disclosed to the borrower?

INTRODUCTION

The case of *Barnett & Ors v RBS* [2015] EWHC 2435 (Ch) (*Barnett*) is a significant borrower-friendly decision of the Chancery Division from August of last year. Essentially, the borrowers in *Barnett* were contemplating redeeming a loan early and were informed by RBS ("Bank") that they would be liable to pay an interest rate swap termination cost of just under £2.4m. The interest rate swap was an internal transaction between departments in the Bank and was not disclosed to the borrowers.

Mr Justice Warren found in favour of the borrowers on the basis that: (i) the internal interest rate swap was not a "funding transaction" within the meaning of the loan agreement; and (ii) in any event, there was no loss to the Bank precisely because the interest rate swap was arranged internally.

A natural question arising from *Barnett* is – if an interest rate swap is linked to *external hedging with a third party*, such that there is loss to the lender on early redemption, would the borrowers be liable to pay the termination cost? Further, would it matter if the existence of this swap was not disclosed to the borrower?

A useful starting point would be to set out three of the methods by which a lender can hedge the interest rate risk associated with fixed rate loans:

- The lender may execute an internal interest rate swap between two departments of the some bank ("Internal Swap").
- The lender may enter into a reverse transaction with another bank which exactly matches the profile of the fixed interest rate loan ("Back-to-Back Swap").
- The lender may enter into a swap with a market counterparty which broadly hedges the lender's risk across its entire portfolio of fixed rate loans ("Portfolio Hedge").

BARNETT & ORS v RBS

Facts

Barnett involved a loan agreement dated 1 April 2004 ("Agreement") between the Bank and members of the Merchant Place Property Syndicate 35 acting by its Trustees ("Borrowers"). The loan was arranged so that the Borrowers could finance the acquisition, development and letting of a property.

There are two key provisions in the Agreement which it is worth setting out. The first is the definition of "loss", which provides:

> 'losses, claims, demands, actions, Proceedings, damages, or other payments, costs, expenses and other liabilities of any kind including, without prejudice to the foregoing generality any costs to the Bank *incurred in the unwinding of funding transactions undertaken in connection with the Facility* and including inter alia costs incurred when there has been a reduction in the market level of interest rate underlying the Facility, such costs to be equivalent to the loss of interest income to the Bank as a result of re-deploying funds at a lower interest rate than that which prevailed when the Facility was made available, such costs to be determined by the Bank in its sole discretion…' (Emphasis added)

The second key provision is cl 12.1(f) which provides that the Borrowers are to indemnify the Bank against any "loss" sustained or incurred as a consequence of 'any cost to the Bank incurred in the unwinding of funding transactions undertaken in connection with the Facility…'.

More than five years elapsed since the date of the Agreement, at which point the Borrowers told the Bank that they were considering redeeming the whole loan. The Borrowers were informed, much to their surprise, that early redemption would come at a cost of £2.396m. The Bank explained that in order for it to have been able to provide the loan at a fixed (rather than floating) rate of interest, it had to enter into an Internal Swap in connection with the facility in order to fund the transaction and hedge the risk of changing interest rates. The Internal Swap was between the Bank's Corporate Banking division and Markets desk (which is not a separate legal entity). The early redemption cost arose as a result of unwinding this transaction.

Judgment

Mr Justice Warren began his analysis by setting out the general principles of construction of commercial documents as laid out in the speech of Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society*[1] and in the judgment of Lord Clarke JSC in the Supreme Court in *Rainy Sky SA v Koomin Bank*.[2]

Having set out these principles, Mr Justice Warren proceeded to construe the term "funding transaction" as a whole, although he engaged with each word separately. He held that the Internal Swap could not be said to be a "transaction" as the context of the definition of "loss" and of cl 12.1(f) envisaged a transaction which takes place between two legal entities.

Mr Justice Warren was less clear, however, on whether the Internal Swap could be construed as "funding" the facility. Arguably it could as it can be said to have assisted the Bank in making the loan available. In any event, there was no need to consider this point further given his finding that an Internal Swap cannot constitute a "transaction".

ANALYSIS

Back-to-Back Swap

In *Barnett*, counsel for the Borrowers submitted that a Back-to-Back Swap would have been encompassed by cl 12.1(f). As this was not an issue before the court, it was not addressed by Mr Justice Warren. However, bearing in mind the ratio of his Judgment, why should Back-to-Back Swaps not be captured by an equivalent contractual provision?

In terms of whether there is a "transaction", a Back-to-Back Swap presupposes the existence of two distinct legal entities. Further, there can be no ambiguity as to whether it is "funding" the loan as it is specific to that loan and matches its profile. In addition, there is no difficulty in proving loss given that this transaction involves a contractual agreement with a third party.

Portfolio Hedge

The Bank raised the argument of a Portfolio Hedge in *Barnett*, although counsel did so by framing it *in tandem* with the Internal Swap as representing the relevant funding transaction. However, given that it was raised so late in the proceedings, Mr Justice Warren decided that he did not have enough material before him to make a call on this issue. While counsel for the Borrowers accepted that Back-to-Back Swaps would be captured by cl 12.1(f), he did not accept that the same was true of Portfolio Hedges.

As with Back-to-Back Swaps, Portfolio Hedges involve a contractual agreement between two distinct legal entities and so should satisfy the "transaction" portion of "funding transaction". The "funding" aspect, however, is less direct. By its very nature, the Portfolio Hedge is intended to encompass a broad range of transactions and so it will be less precise in how it applies to any individual loan. On a macro level, it can be said to provide a lender with the ability to fund any and all of the loans that fall within the scope of the portfolio. However, the more indirect the connection between the method of hedging and the funding, the more reticent a court will be to allow the lender to benefit from a favourable interpretation of a vague contractual term. Indeed, if there is thought to be any ambiguity then, applying the principles of construction derived from the case of *Rainy Sky*, the benefit of the doubt should be given to the borrower.

This is also where the definition of "loss" becomes more pertinent. This is because the loan being redeemed will only be one of many in a portfolio and the commercial reality is that, unless we are dealing with a very significant loan in the context of the portfolio, a lender is unlikely to unwind all or even part of its Portfolio Hedge. This therefore fails to satisfy the "unwinding" requirement and, furthermore, the "loss", such as it is, is far more indirect as it lies in an accounting adjustment.

The further difficulty for a lender in arguing that a borrower is liable for the redemption costs associated with a Portfolio Hedge is that this purported construction of the agreement appears to be unfair and uncommercial. This is because the borrower would suffer the downside of unwinding this transaction (if indeed it is unwound) in the event of early repayment of the loan in circumstances where interest had moved against the lender; however, the borrower would not receive the upside when interest rates had moved in its favour. The borrower could argue that this one-sided exposure of risk should have been explained to them from the outset of the agreement. This same point is true with Internal Swaps and Back-to-Back Swaps, but, again, the weight of this argument is strengthened when it is applied in conjunction with all of the other hurdles faced by Portfolio Hedges, as set out above.

Notice

What about the situation in which a borrower is blissfully ignorant of how fixed rate loans are funded and risks hedged? The situation in which the loan agreement or any connected prospectus makes no reference to an external hedge of any kind. It was said that the prospectus in *Barnett* did no more than prove that hedging was 'within the contemplation of the parties'.[3]

The point being made in *Barnett* is that this is all a matter of contractual interpretation. In arriving at its conclusion, the court is entitled to take into account the relevant surrounding circumstances. If there are two possible constructions then the court is entitled to prefer the construction which is consistent with business common sense.

Clearly, if the relevant matrix includes an awareness on the part of the borrower of the potential funding arrangements in place, then this will be huge for the lender. However, if there is no such awareness, the question will likely be whether the terms of the loan agreement are sufficiently clear to encompass the transaction in question, regardless of whether the borrower was aware of the specific external hedge chosen by the lender. There is no suggestion in *Barnett* that knowledge of the relevant transaction was an overriding consideration for the Court; had it been so, Mr Justice Warren would have based his *ratio* on this point rather than the finding that an Internal Swap does not constitute a "funding transaction".

Biog box
Ognjen Miletic is a barrister practising from Henderson Chambers, Temple, London. Email: omiletic@hendersonchambers.co.uk

Consequently, I would posit that notice to the borrower becomes a far more important aspect of the relevant factual matrix if you have a weaker argument on contractual construction. It follows that a borrower's knowledge of the existence of a swap would not be a primary concern in cases involving Back-to-Back Swaps, but it is brought to the fore with Portfolio Hedges.

Careful drafting

The obvious, though unexciting, answer for lenders lies in the more careful drafting of contractual provisions. There are two schools of thought on this: the first is that the lender could draft the relevant term(s) as widely as possible, and the second is that the lender could draft the relevant term(s) as narrowly as possible.

The decision of the Court of Session (Inner House, First Division) in *Bank of Scotland v Dunedin Property Investment Co Ltd (No 1)*[4] appears to suggest that the lender should adopt the former approach. In that case, the bank agreed to loan Dunedin £10m for 10 years at a fixed interest rate of 12.5% against £10m of debenture loan stock. The loan stock agreement provided that Dunedin would be free to buy back the stock at any time, subject to six months' notice and the reimbursement of all 'costs, charges and expenses incurred by it in connection with the stock'.

In order to hedge its risk, the bank borrowed £10m on a short term loan which would have to be regularly renewed, and also entered into an interest rate swap agreement with an American bank. Dunedin gave its notice and, as a result of the bank terminating the swap agreement, the bank became liable to pay a breakage charge. The Inner House held that the phrase "in connection with" was capable of a wide interpretation and should be understood as covering any cost which had a substantial relationship in a practical business sense with the loan stock.

Interestingly, for our purposes, the court also held that: (i) the swap agreement and the loan agreement were intrinsically connected, such that the bank would not have entered into one without the other; and (ii) it was shown to be within both parties' knowledge that the bank would hedge the loan as they did, and that there would be a cost involved in the early purchase back of the stock, therefore a "commercially sensible construction" of the loan stock agreement was that the costs incurred in the termination of the swap agreement were recoverable from Dunedin.

Given that this case deals with a Back-to-Back Swap, and there clearly was awareness on the part of the borrower of the type of external hedging arrangement that would be entered into, the argument in favour of a broader drafting of relevant contractual term(s) is weakened significantly. If the court was dealing with a Portfolio Hedge, with its less direct connection to the loan in question, both in terms of funding and loss, and a lack of awareness on the part of the borrower, it is highly unlikely that a court would replicate the same favourable result for the lender; the constituent elements which led to the "commercially sensible construction" in *Dunedin* are severely lacking.

It is also worth considering the case of *K/S Preston Street v Santander (UK) Plc*,[5] which similarly concerned the interpretation of a fixed rate funding indemnity. There, cl 6.2 of the loan agreement provided that the borrower would indemnify the lender 'against any costs, losses, expenses or liabilities, including loss of profit or opportunity costs, which the bank incurs' as a result of the borrower repaying the loan during the fixed-rate period. One of the issues before the court was whether the lender was entitled under this clause to recovery for losses incurred up until the date of demand or for extrapolated future losses as well.

His Honour Judge Pelling QC held that cl 6.2 did not entitle the lender to recover its prospective, extrapolated losses. This was not a breach of contract case and cl 6.2 was interpreted strictly with the word "indemnify" suggesting a crystallised liability or obligation falling within the identified class of "costs, losses, expenses or liabilities" that had already been incurred. Accordingly, if the parties had intended for the lender to be entitled to recover future losses, then the clause could have simply used the words "incurred or to be incurred" rather than just "incurs".

This case suggests that the wording of indemnities will be scrutinised mercilessly; it re-emphasises the need for specificity as the court is unlikely to give a lender a great deal of latitude in circumstances where it had such control over the wording of the agreement.

CONCLUSION

The aim for the lender with fixed rate loan agreements is encapsulated by the words of Warren G: 'sign the bottom line, put them on the shelf, break them off some crumbs, keep the rest for yourself.'[6] While the borrower is on the shelf, the lender benefits from fluctuations in the interest rate that are in its favour and is otherwise protected by virtue of interest rate swaps. If the borrower does decide to come off the shelf early then they alone risk suffering the downside of unwinding these swaps when the interest rate moves against the lender without obtaining the upside when the interest rate moves in the borrower's favour.

However, in order to achieve this aim, lenders must be careful in the drafting of indemnity provisions. The analysis in *Barnett* and other cases is useful and intimates that a sufficiently specific clause will likely protect the lender even in circumstances where the borrower has no knowledge of the existence of a hedging transaction; notice and awareness becomes more significant the weaker the argument on construction. ■

1 [1988] 1 WLR 896, 912F–913F.
2 [2011] UKSC 50, [2011] 1 WLR 2900; see para 21.
3 Paragraph 40.
4 1998 S.C. 657.
5 [2012] EWHC 1633 (Ch).
6 *What's Love Got To Do With It* (1997).

Further Reading:

- Should losses on payer swaps be recoverable? [2012] 11 JIBFL 680.
- Indemnities and break costs: How to recover future unascertained loss [2012] 8 JIBFL 474.
- LexisNexis Loan Ranger blog: Bank lenders and internal swaps.