Case No: HC 2014-001284

Neutral Citation Number: [2015] EWHC 2435 (Ch)

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION

Royal Courts of Justice
7 Rolls Buildings
Fetter Lane, London, EC4A 1NL

Date: 14 August 2015

Before :

MR JUSTICE WARREN

- -

Between :

(1) BARNETT WADDINGTON TRUSTEES (1980) LIMITED **(2) DAVID SULLIVAN (BEING THE TRUSTEES OF THE SULLIVAN TRUST)**	**Claimants**
- and -	
THE ROYAL BANK OF SCOTLAND PLC	**Defendant**

- -
- -

Mark Warwick QC and Justina Stewart (instructed by **Kaye Tesler and Co.**) for the **Claimants**
Laura John (instructed by **Addleshaw Goddard LLP**) for the **Defendant**

Hearing dates: 13th May 2015

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Judgment

Mr Justice Warren:

Introduction

1. This Part 8 claim raises a point of construction arising out of a loan agreement dated 1 April 2004 ("**the Agreement**"). The Agreement was made between the defendant ("**the Bank**") of the one part and the parties listed in Schedule 4 to the Agreement being described as "members of the Merchant Place Property Syndicate 35 acting by its Trustees". The largest member of that syndicate by percentage participation was described as "The Sullivan Trust" the trustees of which are the Claimants. I shall refer to the Claimants and the other participants together as "**the Borrowers**".

2. The loan was arranged to finance the acquisition, development and letting of a property at Wildwood Way, Worcester (defined in the Agreement as "**the Property**", a definition I adopt for the purposes of this judgment).

3. The Bank entered into an internal hedging arrangement (which I will explain in due course). The issue before me is whether the Borrowers are liable to indemnify the Bank against any "loss" suffered by the Bank as the result of this arrangement. I put the word loss in inverted commas because one question which arises is whether any "Loss" as defined in the Agreement has been incurred by the Bank in the first place.

The Agreement

4. The following definitions in the Agreement are of relevance:

   i) "Advance": the aggregate principal amount of the drawings by the Borrowers under clause 4.1 (*Drawdown*) or the amount outstanding for the time being.

   ii) "Facility": the term loan facility of up to £9,237,500.

   iii) "Interest Payment Date": each date on which interest is payable under clause 5.

   iv) "Loss": this is an important definition and I set it out in full:

      > "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;"

   v) "Mandatory Costs": such costs (in relation to the Term Loan) as the Bank determines are necessary to compensate the Bank for complying with certain regulatory requirements.

vi) “Margin”: a margin of 1.125% *per annum*.

vii) “Project”: the acquisition of the Property and its development and letting.

viii) “Term Loan”: the aggregate principal amount of the Facility from time to time outstanding and owing to the Bank.

5. Other relevant provisions of the Agreement are these:

i) Clause 2 which provides for the Commitment. The Bank agreed to make available a sterling loan facility of £9,237,500 “available to be drawn on the terms and subject to the conditions of” the Agreement.

ii) Clause 4 which provides for the drawing of the Facility. Nothing turns on this provision other than to note that the entire sum was in fact drawn down.

iii) Clause 5 provides for the payment of interest on the Advance. Interest accrues from the date of drawdown to the date of repayment at the rate determined by the Bank to be the aggregate of

a) the Margin;

b) 5.1% (or such alternative rate as the Bank may certify as applicable); and

c) the Mandatory Costs.

iv) Clause 6 deals with Repayment, Prepayment and Cancellation. Subject to clause 6.2 (which deals with Voluntary Prepayment) and clause 6.3 (which deals with Mandatory Prepayment) the Borrowers are to apply all rental income (with certain exceptions) to repayment of the Term Loan and interest.

v) Clause 6.2 deals with voluntary prepayment and permits the Borrowers to give notice to “prepay the Term Loan or part thereof” together with a repayment fee. That fee was on a reducing sliding scale over 5 years: after 5 years, there was no prepayment fee. Voluntary prepayments were to be for multiples of £100,000. Clause 6.3 provides that the Borrowers must prepay the Term Loan in whole or in part on a disposal (such as a sale) of the Property.

vi) Clause 7 deals with payments. In particular clause 7.3 provides that all payments to be made by the Borrowers are to be made without any set-off, deduction or counterclaim.

vii) Clause 9 provides for the provision by the Borrowers of certain undertakings. All that it is necessary to note is that this clause has nothing express to say about internal hedging arrangements: the Borrowers do not give any undertaking in relation to such arrangements.

viii) The critical provision is found in clause 12, headed “Indemnities”. So far as material, the clause provides as follows:

“12.1 Indemnity

The Borrowers shall indemnify the Bank on demand against any Loss (including any Loss on account of funds borrowed, contracted for or utilised to fund any amount payable under this Agreement, any amount repaid or prepaid under this Agreement or any Advance and any loss of Margin) which the Bank has sustained or incurred as a consequence of:

.....

(d) any prepayment or repayment of the Advance otherwise than on an Interest Payment Date relative to that Advance;

......

(f) any cost to the Bank incurred in the unwinding of funding transactions undertaken in connection with the Facility, including *inter alia* costs incurred when there has been a reduction in the market level of interest rate underlying the Loan. Such costs will 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 their sole discretion.

12.6 General

Each indemnity in this Clause 12 (*Indemnities*) shall constitute a separate and independent obligation from the other obligations contained in the Financing Documents, shall give rise to separate and independent cause of action, shall apply irrespective of any indulgence granted from time to time and shall continue in full force and effect notwithstanding any judgment, decree or order or a liquidated sum or sums in respect of amounts due under the Financing Documents or under any such judgment or order."

ix) Clause 21.2 provides that any certification or determination by the Bank is *prima facie* evidence of the matters to which it relates.

x) Clause 22.5 is a limited recourse provision. Notwithstanding any Event of Default, the Bank is to have recourse only to the extent of the Property or any other asset secured by any of the Financing Documents.

6. It can be seen, therefore, that in summary the Borrowers receive a loan of £9,237,500. It is for a maximum term of 30 years. It provides a fixed interest rate of 5.1%, plus a "Margin" of 1.125%. Clause 6 expressly contemplates repayment of the loan during the term with a prepayment fee being payable in the event of repayment within 5 years.

The dispute in a nutshell

7. More than five years have elapsed since the date of the Agreement and the making of the loan. The Borrowers are considering redeeming the whole loan. The Bank

contends that, as a condition of such redemption, the Borrowers must pay an "Interest Rate Swap termination cost". As at 27 May 2014, this cost was quantified by the Bank at about £2.396 million. I was not told the precise figure as at the date of the hearing but it is clearly substantial. The Borrowers contend that such Interest Rate Swap termination cost is not within the scope of the indemnity contained in clause 12 of the Agreement since it is not a "Loss".

The correspondence concerning the dispute

8. One of the claims made by the Borrowers in the original Claim Form is an inquiry "as to whether the Borrowers (pursuant to the Agreement) are liable to pay to the Defendant, what it calls in its letter of 27 May 2014, an "Interest Rate Swap termination cost", and (if such a liability arises) how, when and why it arises and how the alleged cost is to be calculated".

9. A draft claim form had been provided to the Bank's litigation solicitors, Addleshaw Goddard LLP ("**AG**"). They considered the claim to be defective and not suitable for the Part 8 procedure. In their letter dated 13 November 2014 to the Borrowers' solicitors, AG noted that, since a Part 8 claim was envisaged, they inferred that no issue was taken as to the factual account of the relevant matters concerning the Loan. They also articulated the following deficiencies which they perceived in the draft claim form:

   i) the claim was not seeking the determination of the Court of a specific question but rather asked the Court to order an inquiry into whether the Borrowers were liable to pay any costs arising from the termination of the Internal Swap and, if liable, how these costs were to be determined;

   ii) the request for an inquiry was made without any attempt on the part of the Borrowers to put forward a basis upon which they would not be liable; and

   iii) no attempt was made by the Borrowers to set out why the Bank's explanation relating to their contingent liability (on the termination of an Internal Swap) was not accepted.

10. These complaints were repeated in the first witness statement of Mr Barnett (of AG). Rising to the challenges in (ii) and (iii), Mr Kaye of the Borrowers' solicitors, in his second witness statement, explained the Borrowers' case. I do not propose to deal with what he says, all of which is subsumed in the submissions made to me by Mr Warwick and Ms Stewart in their written and oral submissions.

11. I am not much attracted by Mr Barnett's point or with adjudicating on this particular spat. Clearly what the Borrowers are seeking in the original Claim Form is an answer to the question whether they would be liable for this cost if they were to prepay the loan. In any case, this does not much matter because the Claim Form has been amended to include a new paragraph seeking a declaration "that the Borrowers are not liable to pay [the Bank] any sum in respect of the "Internal Swap" as described at paragraph 13 of the witness statement of Michael Felix Barnett dated 2 December 2014". That paragraph is set out at paragraph 17 below.

The internal interest rate swap

12. The letter of 27 May 2014 referred to in the Claim Form appears in a chain of correspondence in which the Borrowers' solicitors were seeking to ascertain the amount due in order to redeem the Facility or, in other words, what would be due if the Borrowers made prepayment of the outstanding loan. The letter from AG dealt with hedging under the heading "Interest Rate Hedging". I set out the relevant text:

> "You mention that the Bank has previously stated that no interest rate hedging affects this case. This is not accurate. The Bank has maintained the position, and still does, that the Merchant Place Property Syndicate was not sold an interest rate hedging product and that this was not a condition of the finance.
>
> The position is that on 1 April 2001, Merchant Place Syndicate 35 entered into a Loan Agreement with the Bank. .....
>
> In order for the Bank to be able to provide this loan at a fixed (rather than floating) rate of interest, the Bank itself had to enter into an interest-rate swap in connection with the facility in order to fund the transaction and hedge the risk of changing interest rates.
>
> As set out in the Loan Agreement, your client remains liable and agreed to indemnify the Bank for any loss incurred if this funding transaction has to be unwound i.e. break costs for terminating this swap early to match any earlier repayment of the loan itself.
>
> It is for this reason that your client has, on a number of occasions, been provided with figures from RBS employees in respect of both the principal loan balance (plus interest) and the prevailing Mark-to-Market or MTM on the swap."

13. The nature of this interest rate swap is not clear from that letter. In later correspondence, in which the Borrowers' solicitors pressed the Bank for further information and documentation concerning these hedging arrangements, the Bank repeated, in its letter dated 10 June 2014, that it had to enter into an interest rate swap in order to be able to provide a fixed-rate loan. Later, it referred in its letter dated 24 June 2014 to "the Bank's internal interest rate swap being unwound as a consequence [*ie* of early repayment]". The swap was again referred to as an "internal" swap arrangement in the Bank's letter dated 9 July 2014 where it is asserted that the Bank was able to offer a fixed rate loan "because of the internal swap arrangements being in place".

14. Not fully understanding the position, the Borrowers' solicitors wrote to the Bank on 11 September 2014 seeking details of every funding transaction which the Bank had undertaken in connection with the loan and various other details. This was clearly directed primarily at finding out the nature and details of the interest rate hedge which would need to be unwound if the loan were repaid early. The last letter in this chain of correspondence to which I refer was from the Bank. It is dated 20 October 2014. The Bank wrote:

> "Given this, it is implicit that there are no other funding transactions aside from the interest rate swap set out in the redemption figures.
>
> ......

> We consider we have responded to your query: there are no other funding transactions in connection with the Syndicate's loan facility, aside from the internal interest rate swap which has been the subject of our ongoing correspondence."

15. The reader of this correspondence would have no reason to think that the hedging transaction to which the Bank was referring was other than a purely internal matter although I am bound to say that, at that stage in October 2014, the nature of the internal arrangements had not been adequately explained to the Borrowers' solicitors or, indeed, at all. There is no reference in the correspondence to an external hedge with a third party: if there had been one, it might have been expected that the Bank would have given to the Borrowers some information about it. But this was not done. In any case, if there had been anything other than some internal arrangements, the second passage quoted from the 20 October 2014 letter would have been wrong.

16. On any view, and the Bank does not suggest otherwise, there was no hedging agreement entered into between the Borrowers and the Bank.

17. The Bank's position following the commencement of this litigation is set out in Mr Barnett's first witness statement. It is worth setting out paragraph 13 of that statement under the heading "Funding of the Loan":

> "As is common with fixed rate loans (particularly long term fixed rate loans), the Bank itself entered into an interest rate swap to fund the interest on the Loan and to hedge the risk the Bank faced on the possible fluctuation in interest rates in providing the (fixed rate) Loan (**Internal Swap**). The Internal Swap is between RBS Corporate Banking division and RBS Markets, the interest rates desk which is responsible for hedging all of the Bank's interest rate risk (including the Bank's risk in funding the Loan) with market counterparties on a portfolio basis."

18. Mr Barnett makes no mention of any interest rate swaps by the Bank with third parties in relation to the loan to the Borrowers. It appears from paragraph 13 of his witness statement that the internal swap had two purposes: one to fund the interest and the other to hedge the risk. What Mr Barnett means by funding the interest on the loan is explained in paragraph 11 of his second witness statement. I come to that next. In summary, it shows that it is not the interest on the loan (*ie* the loan to the Borrowers) which is funded by the internal interest rate swap: rather it is the interest on the floating rate borrowings by Corporate Banking from Group Treasury using the words "interest" and "borrowings" to describe the arrangements between those two different departments of the Bank.

19. Mr Barnett's second witness statement was made following the amendment of the Claim Form in the terms set out in paragraph 11 above and in response to Mr Kaye's second witness statement. I set out verbatim the sub-paragraphs of paragraph 11 of that witness statement:

"(a) The Bank's Corporate Banking business (which is not a separate legal entity from the Bank) agreed to lend money to MP35, under the Loan Agreement, at a fixed rate of interest.

(b) Prior to the date set for drawdown of the Loan, Corporate Banking obtained the money it had agreed to lend to MP35 by borrowing it from the Bank's Group Treasury (also not a separate legal entity from the Bank) at a floating rate. The floating rate reflected the cost incurred by Group Treasury in making the funds available.

(c) The floating rate cost of obtaining the money from Group Treasury is funded by the interest rate payments received from MP35 under the Loan Agreement. In this case, those interest rate payments are fixed.

(d) Receiving a fixed rate of interest under the Loan Agreement therefore exposed (and exposes) the Bank to the risk that, if interest rates went above the fixed rate, it would have insufficient incoming payments under the Loan Agreement to pay the floating rate at which it had funded the Loan (that exposure will be particularly acute under a long term loan, as here).

(e) In order to fund any future shortfall between the fixed rate of interest received under the Loan Agreement and the floating rate of interest being paid to Group Treasury, and as part of funding the Loan, Corporate Banking entered into the Internal Swap with the relevant Markets desk (in this case, the sterling rates Markets desk) for the relevant tenor, rate and notional amount, essentially mirroring the characteristics of the Loan. The Markets desk sits within the Bank, and is not a separate legal entity.

(f) The Markets desk will, in turn, fund the Internal Swap by entering into an interest rate swap with an external market counterparty. As set out in my first witness statement, the Markets desk manages the Bank's sterling interest rate risk on a portfolio basis by aggregating that interest rate risk. This means that each sterling swap booked internally is not necessarily funded externally on a "back to back" basis.

(g) The Internal Swap is, therefore, a funding transaction without which the Bank would not be able to offer the (fixed rate) Loan, the costs of unwinding of which is a cost of the *"unwinding of funding transactions undertaken in connection with the Facility"* (clause 12.1 (f) of the Loan Agreement)."

The Prospectus

20. The loan was taken out in connection with an investment opportunity (or "Project") described in a prospectus prepared by Merchant Place Corporate Finance Ltd ("**the Prospectus**"). It described an opportunity for the applicants to acquire the Property, being new offices, which were to be let to Worcestershire County Council ("**WCC**"). The Project was structured so that the total acquisition cost of the Property was £10,750,000 of which £9,137,500 was described as a "limited recourse loan, fixed for 30 years at cost of funds plus 1.125%" such loan to be advanced by the Bank. On page 25 of the Prospectus, applicants were instructed to remit their contributions to a specified account: this was an account with the Bank (which was specifically named as Royal Bank of Scotland at its Threadneedle Street address). The Bank does not suggest that it did not know the contents of the Prospectus when the Agreement was signed.

21. The Prospectus contained a number of provisions to which I have been referred:

i) On page 7, headed "Lease and Minimum Lease Payments" it was stated that WCC would take a 30 year lease. However, it was stated that WCC had the right to buy back the Property at the end of 15 years at open market value (although it was considered unlikely that WCC would in fact exercise the option)

ii) On page 8, under the heading "Interest Rate" it was stated that interest would be fixed for 30 years at cost of funds plus 1.125% over long-term interest rates. One then finds this: "It is intended to fix the cost of funds by entering into suitable hedging contracts".

iii) On page 9, headed "Financial Analysis" it was noted that the Partnership (*ie* the investors) could decide to dispose of the Property at any time. Two examples were given of disposals after 5 and 15 years. A table was included showing the outstanding debt figures at an assumed interest rate of 6.2%. Under the table appeared the following:

> "*Please note, the figures above do not take account of selling costs, taxes or any cost or benefit of unwinding interest rate hedging.*"

Principles of construction

22. The approach to the construction of commercial documents such as the Agreement is well known and is common ground. The legal principles are set out in the speech of Lord Hoffmann in *Investors Compensation Scheme Ltd v Wet Bromwich Building Society* [1988] 1 WLR 896 especially at 912F to 913F and in the judgment in the Supreme Court of Lord Clarke JSC (with whom the other judges agreed) in *Rainy Sky SA v Koomin Bank* [2011] UKSC 50, [2011] 1 WLR 2900 ("***Rainy Sky***"). It is not necessary to repeat the oft cited passage from Lord Hoffmann's speech, but it is worth setting out paragraph 21 of Lord Clarke's judgment in *Rainy Sky.*

> "21. The language used by the parties will often have more than one potential meaning. I would accept the submission made on behalf of the appellants that the exercise of construction is

> essentially one unitary exercise in which the court must consider the language used and ascertain what a reasonable person, that is a person who has all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract, would have understood the parties to have meant. In doing so, the court must have regard to all the relevant surrounding circumstances. If there are two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense and to reject the other."

The relevant matrix

23. The Agreement was, of course, made in the context of the purchase of the Property. That context is explained in more detail in the Prospectus. The Bank was the bank expressly mentioned in the Prospectus and was the entity to which monies were to be sent by the investors. It was the Bank which was going to make available the non-recourse facility. It is plain, and the Bank does not suggest otherwise, that it knew that potential investors would be given the information about financing which was contained in the Prospectus. It is permissible to pay regard to the contents of the Prospectus when construing the Agreement in order to establish the background to the making of the Agreement.

24. The internal arrangements of the Bank are not part of the factual matrix against which the Agreement is to be construed. There is nothing to suggest that the Borrowers were aware of the way in which the Bank funded or hedged loans which it made to its customers. It is not suggested that the Bank's internal arrangements ought to have been known by the Borrowers.

Construction

25. There are four points which I would note at the outset. The first is that the Agreement says nothing expressly about hedging, whether by an internal arrangement of some sort or by an agreement with a third party. The Agreement could have stated, but did not state in clear terms that the Bank would be entitled to enter into an internal or external interest rate swap and that the Borrowers would be liable for any break costs arising as the result of the early termination of the swap.

26. The second point to note is that the Internal Swap is not a contractual arrangement. It is, on the Bank's own evidence, simply an arrangement between two departments within the Bank, namely Corporate Banking and the sterling rates Markets desk. It is separate from, although it may lead to, some contractual hedging arrangements with third parties "on a portfolio basis" according to the Bank's evidence.

27. The third point to note is that Mr Barnett's evidence (given on the basis of information provided by the Bank) is that prior to the date for drawdown of the loan (it is not revealed whether this was before or after the date of the Agreement) Corporate Banking obtained the money it had agreed to lend to the Borrowers "by borrowing it from the Bank's Group Treasury....at a floating rate". This, again, was not a contractual arrangement since Group Treasury, too, is a department of the Bank. There was no borrowing in the ordinary sense of the word as giving rise to an

enforceable obligation by one person (the borrower) to repay money loaned to another person (the lender) when the loan fell due for repayment. The "borrowing" and the floating rate "interest" payable were virtual constructs for the internal financial and accounting purposes of the Bank.

28. The fourth point is a rather longer point and concerns precisely what it is that I am to decide. The Claim Form was formulated in the light of the correspondence and the position which the Bank had taken. The Borrowers' solicitors had consistently (albeit misguidedly or unreasonably in the Bank's view) sought details of the funding transactions on which the Bank would rely were the Borrowers to make a prepayment. Like a mortgagor seeking to redeem, the Borrowers sought the basis on which the Bank had based its calculations of the amount which would fall due. Although clause 21.2 of the Agreement provides that any certification or determination by the Bank is *prima facie* evidence of the matters to which it relates, the provision of figures is no more than *prima facie* evidence of the correctness of the figures. It does not mean that the Bank can simply decline to explain the legal basis on which the calculation is based. In the end, the Bank, in its letter dated 20 October 2014, pinned its colours to the Internal Swap as the relevant funding transaction, expressly disavowing reliance on any other funding transaction.

29. It was on that basis that the original Claim Form was drafted. The complaints about the deficiencies of the Claim Form did not go to that aspect of the dispute. The Borrowers' case in the litigation has always been that the funding transaction relied on by the Bank (and it was in fact the only funding transaction relied on by the Bank until much later as I will explain), that is to say the Internal Swap, was not within the scope of clause 12.1(f) of the Agreement. In case the Claim Form did not seek the right relief in the light of AG's observations about its deficiencies, the amendment which I have already mentioned was made. It did not, in my view, introduce a new claim which would have justified the Bank in saying that a totally new point was now being made and that it was not, after all, the case that there was some funding transaction other than the Internal Swap which would give rise to an indemnity under clause 12.1(f) were the Borrowers to make early payment.

30. I had thought, before the hearing began and having read Ms John's skeleton argument, that the Bank's case remained that the relevant funding transaction was the Internal Swap. But as the argument developed, it became apparent that this was not so. It remained her primary position, on behalf of the Bank, that the Internal Swap was the relevant funding transaction. But if that was not so, then the relevant funding transaction was the Internal Swap taken together with the arrangements with third parties by which the Bank manages its risk on a portfolio basis.

31. I will, of course, answer the question raised in Claim Form which is whether the Internal Swap is a relevant funding transaction. I will also deal to some extent with the issue whether the Internal Swap taken together with any sort of external hedging is a relevant funding transaction. But I will not address (other than tangentially) the question whether an external hedging transaction is capable of being a relevant funding transaction. I will not do so because it has not been argued, or at least properly argued, and whether the particular arrangements entered into by the Bank with third parties which cover its exposure in relation to the loan to the Borrowers will depend on the details of how the Bank manages its risk on a portfolio basis. As to that, I have no evidence but only some rather general explanations given by Ms

John and which, even if they were uncontroversial, are not of sufficient detail to enable me to reach a conclusion.

32. Whether the Bank is precluded from relying on such arrangements as relevant funding transactions for the purposes of clause 12.1(f) is not a matter for me in this litigation. The Borrowers may have a case for saying that the Bank is precluded from doing so having allowed the Borrowers to come to court on the clearly stated basis that the Bank was relying only on the Internal Swap as the relevant funding transaction. Further, although Ms John did set out the secondary position that the relevant transaction was the Internal Swap together with the external arrangements on a portfolio basis, she did not seek to argue that the external arrangements alone were a relevant funding transaction. No doubt she would say that she did not do so because that was not a question raised by the Claim Form. But if the point is raised in the future, it may be that the reason it was not raised by the Borrowers on the Claim Form will be relevant to whether it can, at that future time, be raised by the Bank, that reason, of course, being that the Borrowers were told by the Bank that the only relevant funding transaction was the Internal Swap.

33. That deals with the four points which I wished to note before turning to the substance of the construction issue to the extent that it is raised on the Claim Form, the matter to which I now turn.

34. In order to establish that the indemnity in clause 12 is apposite to cover the impact of early payment of the "loan" on the Internal Swap, the Bank needs to show that the Internal Swap was a "funding transaction undertaken in connection with the Facility". Clause 12.1(f) is not particularly well drawn. The introductory words of clause 12.1 provide an indemnity in relation to any Loss arising from the matters listed in paragraphs (a) to (f). The words "funding transaction undertaken in connection with the Facility" appear in the definition of Loss, so that reading the definition of Loss with paragraph (f) appears to give rise to some repetition or circularity. However, the sense is, I think, clear so that the indemnity is given in relation to any cost incurred in unwinding a relevant funding transaction (at least where there is a good reason for unwinding it).

35. The Borrowers' case is that Internal Swap is not such a funding transaction. This is because:

   i) It is not a **funding** transaction. A funding transaction is a transaction entered into by the Bank in order to provide the £9,237,500 facility to the Borrowers. It does not refer to an associated hedging transaction which the Bank has chosen to undertake alongside a funding transaction.

   ii) It is not a funding **transaction**. A transaction (in both the definition of Loss and in clause 12.1(f)) is something which takes place between two parties. The Bank cannot transact with itself. The Internal Swap is an arrangement between different departments of the Bank and is not a transaction for these purposes. Contrary to Mr Barnett's explanation (on instructions from the Bank), Corporate Banking cannot borrow from, or pay interest to, Group Treasury.

iii) There is a related point (which has been referred to as the evidential point). It is that the Bank has produced no evidence of any relevant transaction. However, Ms John handed up during the hearing a letter dated 1 April 2004 which comprises the Internal Swap. Interestingly, the "parties" are "The Royal Bank of Scotland plc" and "The Royal Bank of Scotland plc Re Merchant Place Worcester" that letter being on the Bank's letterhead with its Financial Markets address in Bishopsgate and being addressed to the Bank's Glasgow premises marked "Attn: Swaps Department". There is no mention of Corporate Banking (although it may, I surmise, be based at Bishopsgate) so that the letter appears to envisage the Bank (rather than a department of the Bank) dealing with the Swaps Department.

iv) The Bank does not sustain or incur any loss (within the opening words of clause 12.1) and there is no cost (within clause 12.1(f)) to the Bank when the Internal Swap is unwound. The Bank's financial position remains precisely the same whether or not the Internal Swap is unwound. Internally, the result of unwinding the Internal Swap may be that one department of the Bank needs to account to another department for a sum of money, but that does not give rise to a cost within clause 12.1(f) which expressly refers to "any cost to the Bank". The Bank's financial position may be affected as a result of any consequential change to the external interest rate swaps which it has entered into in relation to the Internal Swap, but that is an entirely different issue.

v) Paragraphs (d) and (f) of clause 12.1 are to be read together. In the case of prepayment other than on an Interest Payment Date, the Bank is entitled under paragraph (d) to an indemnity in respect of any Loss incurred in consequence of that pre-payment. The Agreement does not, therefore, envisage the indemnity biting where the prepayment is in fact made on an Interest Payment Date. Paragraph (f) should not be read as permitting any Loss to be recovered, nonetheless, where the event giving rise to the alleged Loss is prepayment on an Interest Payment Date.

vi) The construction for which the Bank contends would be unfair and uncommercial. The Borrowers would suffer the downside of unwinding the Internal Swap in the event of early repayment of the loan when interest rates had moved against Corporate Banking but would not obtain the upside when interest rates had moved in its favour.

vii) If, contrary to those submissions, there is thought to be an ambiguity, it should be resolved in favour of the Borrowers applying *Rainy Sky* principles. As to that:

a) first it is to be noted that the parties did not enter into any hedging contract, including one which would expose the Borrowers to the costs of unwinding such a contract;

b) secondly, clauses 6.1 and 6.2 provide a carefully constructed mechanism for repayment of the loan. Clause 12.1(f) should not be construed so as to give rise to an indemnity in the event of the application of those clauses. In particular, it is to be noted that clause 6.2 would operate if there were a sale of the Property. As was apparent from the Prospectus, WCC would have the right to buy back the Property after 15 years. It would be surprising if as result of such buy-back, the Borrowers could become liable for a potential large cost of unwinding an Internal Swap about which they knew nothing. Those clauses refer to "Prepayment fees" and yet make no mention of hedging fees; and

c) thirdly, clause 5 has specific provisions for the payment of interest at a fixed rate. Unless the parties had agreed that the Borrowers should bear any adverse consequences to the Bank of moving interest rates, there is no commercial reason why these adverse consequences should be borne by the Borrowers. The Borrowers were entitled to assume that the interest rate (whether it was chosen by the Bank or resulted from a hard-fought negotiation) was set at a rate and in a manner with which the Bank was content without a hidden risk resting on them.

viii) Clause 12.1(f) is uncertain. It is not suggested that the Agreement is uncertain but it is submitted that the Court can say this particular provision is too vague to be given any meaning. Reliance is placed on Lewison *The Interpretation of Contracts (5th ed)* at 8.15 including example 5 on p 450. Mr Warwick also referred to *Financial Institutions Services Ltd v Negril Holdings Ltd* [2004] UKPC 40 ("***FISL***").

36. Ms John accepts on behalf of the Bank, indeed, it is as I have said already her primary submission, that the relevant funding transaction is the Internal Swap. The Internal Swap was made, she also accepts, between two divisions of the Bank, what she described as accounting entities. She accepted also that no loss would arise to the Bank if the matter were wholly internal. However, she says that there is an external hedge "on a portfolio basis" and submits that this is enough to bring the case within clause 12.1(f). In other words, as I see it, the argument is that clause 12.1(f) covers the cost to the Bank of effecting a change in the portfolio which follows on from the Bank unwinding the Internal Swap; and this is so even though the unwinding of the Internal Swap is not the immediate source of the cost but only the trigger for action by the Bank which results in that cost.

37. Ms John makes the point that the Borrowers were sophisticated investors, advised by reputable lawyers. The latter is certainly the case although what relevance it has to construction I do not understand. As to the former I do not know, but I will assume it to be correct; it does not follow, however, that they are to be taken to know of the internal arrangements within the Bank. Nor does it follow that they are to be taken to understand that a long term loan by one of the largest Banks in the United Kingdom at a fixed rate would inevitably involve it in entering into interest rate swaps.

38. Ms John makes the point that the Borrowers would have known that hedging was "on the radar". That is certainly the case as can be seen from the Prospectus in the passages which I have mentioned at paragraphs 21 ii) and iii) above. I do not think that takes matters very far. No hedging contract was entered into by the Borrowers and they did not know anything about the internal arrangements within the Bank. It certainly does not follow from the Prospectus that the Borrowers should have understood that the Bank itself would be entering into interest rate swaps with third parties to protect itself from any risk arising from a fixed rate loan to the Borrowers,

let alone that it would do so on a managed portfolio basis. Although admissible as part of the factual matrix, the Prospectus does no more than show that hedging was within the contemplation of the parties.

39. The fact that an interest rate swap is mentioned in the Prospectus shows, Ms John submits, that it was to be seen as part of the funding of the loan. I do not think it is entirely accurate or helpful to describe the swap as part of the funding of the loan; it would be better to have described it as a funding transaction in relation to the loan. Had the loan been at a floating rate and had it been coupled with an interest rate swap to fix the rate of interest (as envisaged by the Prospectus) then it would, I accept, be accurate to describe the swap as a funding transaction undertaken in connection with the Facility. Whether an interest rate swap between the Bank and a third party to cover its risk on the loan to the Borrowers, where that is part of the Bank's risk management on a portfolio basis, is a funding transaction undertaken in relation to the Facility is a different question.

40. As part of her submission in relation to the Prospectus, Ms John has referred to the note under the examples to which I have referred at paragraph 21 iii) above. As I have already said, although it is admissible as part of the factual matrix, the Prospectus does no more than show that hedging was within the contemplation of the parties. But if this particular detail leads anywhere, it seems to me to be a point against the Bank's case rather than in its favour. This is because the example demonstrates quite clearly that the sort of hedging transaction in the contemplation of the Prospectus was one entered into by the Borrowers under which they would not only bear the cost but also take the benefit of the unwinding of any interest rate hedging. It is clear, however, that the Agreement does **not** provide for the Borrowers to obtain the benefit of any unwinding of the Bank's Internal Swap or of its interest rate swaps with third parties. The Borrowers may want to sell – or in limited circumstances may be compelled to sell to WCC – so that it is no answer to this point to say that they do not need the benefit because they can simply retain the Property and continue paying the fixed rate. This is the argument made by Mr Warwick as recorded at paragraph 35 iv) above. It is a pointer to the Borrower's construction.

41. As to the argument based on clauses 6.2 and 6.3, Ms John suggests that it would have been inapposite to include the unwinding costs under the indemnity within those clauses because the indemnity might not bite in all cases in which those clauses apply, for instance where there is no cost in the light of market conditions (and she adds that these costs are not properly to be described as fees in any case). Further, clause 10.2.1 provides for an indemnity in relation to certain matters arising as a result of a change of law. When the Borrowers are obliged to pay an amount under this indemnity, they are given the option to repay the loan. They are also required to pay "all accrued interest and other sums due under this the Financing Documents". The word "this" has clearly been included in error after "the". Any fee due under clause 6.4 is not required to be paid, but this is without prejudice to clause 12. So clause 6 and clause 12 are not mutually exclusive. I agree with those points. In my view, clause 6 is of no assistance in resolving the proper interpretation of clause 12.1(f).

42. As to the argument that paragraphs (d) and (f) of clause 12.1 are mutually exclusive (see paragraph 30 v) above) Ms John points to clause 12.6 (which I have set out at paragraph 12 viii) above). I agree with her that this provides a complete answer to Mr Warwick's point.

43. As to the point made by Mr Warwick (see paragraph 30 vii) above) (*ie* that the parties did not enter into any hedging contract which would expose the Borrowers to the costs of unwinding such a contract) Ms John submits that the result of clause 12.1(f) is that the Borrowers **are** exposed to such costs. In other words, as I see it, she is saying that Mr Warwick's submission begs the very question at issue. I do not think that Ms John's own submission is quite fair to Mr Warwick. He was making the point that there was no interest rate swap entered into by the Borrowers. Their alleged liability in respect of hedging comes directly by way of an Internal Swap and indirectly by way of an external swap neither of which they had any knowledge of. The point is that it is surprising to find the Borrowers fixed with the commercial liability on the unwinding of an interest rate swap (but not the benefit of it) without some express reference to it.

44. Ms John explained to me something which was not in evidence – and I do not think this makes any different to the answer I would reach without it – that the Bank operates a "flat" book. In other words, it hedges in a way so that it takes no risk. Once a borrower (such as the Borrowers in the present case) ceases to be liable to pay interest (because the relevant loan has been repaid early), the Bank nonetheless remains liable to the market counter-party. This is so even though the "flat" book is on a portfolio basis.

45. And so, "What happens when early repayment is made?" one might ask and I did ask. To which the response was "Lots of different things could happen". But later, I was told that the Bank adjusts its portfolio of external contracts so that the book remains "flat". In that case, the loss suffered by the Bank is said to be the net present value of the loss of interest (which is reflected, I imagine, in the description of the costs found in the definition of "Loss" and in the last sentence of clause 12.1(f)). That is not a matter which I propose to address and I confess to having insufficient understanding of how the portfolio operates to form a view about it.

46. As Ms John puts it, the unwinding of the Internal Swap has an effect on the external position and the rebalancing of that external position gives rise to a cost to the Bank which is a "cost" within the meaning of clause 12.1(f).

47. She accepts that, if the Bank were, for some reason, to choose to unwind the Internal Swap without the loan having been repaid, it would suffer no loss since it retains the whole income stream which it was expecting to receive. That is why she identifies the cost of unwinding the Internal Swap when the loan is repaid as reflecting the loss of that income stream. I agree with the conclusion that the Bank would suffer no loss; I would add that it is also the case, in my view, that it would not suffer a "Loss" either. But this is not so much because it retains the income stream but because it has not incurred any cost. Everything is internal to the Bank and it, in contrast with its different departments, is in precisely the same position both before and after the unwinding of the Internal Swap.

48. As to the void for uncertainty point, Ms John submits that, although there are competing interpretations, this is not a case where the provision is conceptually uncertain. The facts are very different from those in *FISL* which, as with the passages cited from Lewison, provides no useful assistance.

49. The point was also made that Mr Warwick has at no stage indicated what clause 12.1(f) does cover if it does not cover the facts of the present case. As to that, Mr Warwick accepted, in his reply submissions for the purposes of the present claim, that a specific hedging transaction by the Bank with a third party, back to back with the Facility, would be covered by clause 12.1(f). But he did not accept that it would include the external hedge arrangements on a portfolio basis which the Bank in fact transacted with third parties. As I have already explained, that is not an issue which is raised on the Claim Form and is not one which I am willing to address.

Discussion and conclusions

50. In my judgment, the Internal Swap is not a funding transaction within the meaning of the definition of Loss or of clause 12.1(f). Those two words must be construed together, and must be so construed in the context of the relevant provision as a whole. Mr Warwick's argument treats each word separately. It is not unhelpful to do so because if there is neither "funding" nor a "transaction" separately inevitably there is no "funding transaction". I prefer to treat the two words together since the meaning of one, in the composite, informs the meaning of the other.

51. Having said that, I nonetheless start with the meaning of "transaction" by itself. I do so, first, on the counter-factual hypothesis that the Internal Swap had been effected without any external hedging being undertaken. In those circumstances, it is clear, in my view, that there would have been no "transaction". The contexts of the definition of "Loss" and of clause 12.1(f) envisage a transaction which takes place between two different legal entities; different departments of the Bank do not qualify as separate entities. Corporate Banking cannot borrow from Group Treasury nor can it pay interest to Group Treasury. These are all internal arrangements within the Bank, effected for its own purposes.

52. If, contrary to that conclusion, the Internal Swap would have been a "transaction" it is not clear, to my mind, whether the transaction would have been a "funding" transaction. It might be said that the (internal) transaction assisted the Bank, through Corporate Banking, in making the loan available. And it can be argued that the transaction would be a "funding" transaction. However, given the meaning of "transaction" which I consider to be correct, it follows that there is no "funding transaction" and it is not necessary or helpful to consider whether the non-transaction can be described as "funding".

53. Moving away from that counter-factual hypothesis to the actual facts where some sort of external hedging has been undertaken, the question is whether that conclusion is altered. In my view it is not. The external hedging may, itself, be a funding transaction within clause 12.1(f); and the Internal Swap and the external hedge may, or may not, be viewed as a single arrangement constituting a financial transaction within clause 12.1(f). However, whether or not the Internal Swap is of itself a financial transaction does not depend on the action taken by the Bank to protect its commercial position. The external hedge is, after all, undertaken with a third party to protect the Bank against the risk it has incurred in relation to the loan to the Borrowers. It is not undertaken to protect the Bank against the risk of the Internal Swap because that risk is not a risk of the Bank at all. The Bank's position (in contrast with inter-departmental arrangements) is entirely neutral so far as concerns the Internal Swap.

54. This construction is, in my judgment, not displaced by any of the factors on which Ms John relies. I have addressed some of them already. I do not propose to deal with any of the others, which carry, in my view, very little weight, other than to say something about one of Mr Warwick's arguments. This is the argument that the Internal Swap gives rise to no loss incurred by or cost to the Bank. The point only arises, of course, if the Internal Swap is, contrary to my conclusion, a funding transaction. If that is wrong, however, it is nonetheless clearly correct to say that the Internal Swap, viewed on its own, gives rise to no loss or cost: indeed, Ms John accepts that proposition as I have recorded in paragraph 36 above. As to her submission that the Internal Swap does give rise to a loss and a cost because of the winding-up of the external hedge in consequence, I disagree. The Internal Swap does not, give rise to any loss or cost to the Bank even though the external hedge may only have been entered into because of the Internal Swap.

55. I turn then to Ms John's secondary submission that the Internal Swap and the external hedging on a portfolio basis can amount to a "funding transaction". Let me take this in stages:

i) if an external hedge (whether a back-to-back arrangement or part of risk management on a portfolio basis) is a "funding transaction" then it does not matter whether or not the Internal Swap can be taken together with the external hedge as a single "funding transaction". It adds nothing to the indemnity which will bite without need to refer to the Internal Swap at all.

ii) if an external hedge cannot be a "funding transaction" (or at least if the particular external hedge in question, in the present case on a portfolio basis, cannot be a "funding transaction") then, in my view, it cannot be maintained that taking the Internal Swap and the external hedge together produces a "funding transaction". If neither component qualifies as a "funding transaction", the composite does not do so either.

iii) Although Mr Warwick accepts that a back-to-back hedge is a "funding transaction", he does not accept that that is the case in relation to the actual arrangements in the present case. For reasons already given, that is not an issue on the Claim Form and I do not have the material to decide it.

iv) I can therefore neither accept nor reject Ms John's secondary submission. Whether the point can be raised in the future is a matter I have touched on at paragraph 32 above.

Disposition

56. I will make the declaration sought by paragraph 3 of the Amended Claim Form to the effect that the Borrowers are not liable to pay to the Bank any sum in respect of the Internal Swap. But this is not to be taken as a decision that the external hedging arrangement on a portfolio basis in the present case is not a "funding transaction" within the meaning of the definition of "Loss" or within the meaning clause 12.1(f). I am not, however, concerned in this litigation with any question whether it is open to take that point at any later stage.