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Swiss Federal Supreme Court: No Negative Interest Rates in Loan Agreements

The Swiss Federal Supreme Court ruled, for the first time, in its decision 4A/596 of 7 May 2019 that a loan agreement does not, in the absence of any contractual arrangement to the contrary, entitle the borrower to payment of "negative interest." This decision also strongly suggests that the lender may remain entitled to receive its contractual margin, even when the reference rate turns negative. This case brings legal certainty to old loan agreements. However, the Court treaded carefully and focused on interpreting the agreement rather than making any broad pronouncement.

Facts

In the case under consideration, the borrower had entered in 2006 into a loan documented in a certificate evidencing indebtedness *(Schuldschein)* for a principal amount of CHF 100,000,000. The loan agreement had a fixed term of 20 years and provided for a floating interest rate based on the sum of the 6 months CHF-LIBOR plus a margin of 0.0375% p.a. payable on a half-yearly basis. In 2012, the defendant acquired a participation of CHF 50,000,000 in the loan. In 2015, the CHF-LIBOR fell below zero and has remained negative ever since. As a consequence, the borrower asked the defendant to pay the negative interest on the loan, as the sum of the 6 months CHF-LIBOR plus a margin of 0.0375% p.a. was below zero. When the defendant refused, the borrower sued. After the lower courts had turned down the suit, the borrower appealed to the Swiss Federal Supreme Court.

Interest is the Consideration for a Loan

The Swiss Supreme Court started its reasoning by stating that a commercial loan is deemed to carry interest unless the parties agreed to the contrary and that, by default, the interest rate is set by contract. However, the Court held that a negative interest could not lead to an inversion of the payment obligation, because otherwise, the borrower would no longer be providing consideration for the loan. This being said, the Court held that nothing prevented the parties from agreeing to the payment of negative interest. It also noted that negative interest is regarded by scholars as a cost payable by the lender rather than an actual interest.

In the case at hand, however, the loan agreement did not address the issue expressly and the real intent of the parties could not be identified. Therefore, the Court needed to engage in an objective interpretation of the contract. Before doing so, it identified three doctrinal approaches to handling the consequence of reference rates becoming negative: the first one considers that a loan agreement implies a floor to the reference rate at zero and, therefore, the borrower always owes the margin to the lender. A second theory considers that loans cannot yield negative interest and, therefore, a lender can never be obliged to pay out negative interest. However, this view

allows negative LIBOR to eat into the margin. A third theory maintains that if the parties rely on a formula to set the interest rate, they accept that the interest rate may be negative and consequently agree that an inversion of the payment flow may occur.

The Swiss Federal Supreme Court did not conclusively settle the doctrinal dispute. However, it ruled that, in the light of the circumstances and without any element in the contract suggesting that the parties could have considered that interest rates may become negative, an objective interpretation of the agreement excluded any payment of negative interest. Moreover, it considered, in obiter dictum, based on an objective interpretation of the contract that, when the parties initially entered into the agreement, they had not contemplated the possibility that the LIBOR would ever be negative. Therefore, it was more likely than not that the parties intended that the lender would earn its margin in all circumstances. The Court stopped short, however, from reaching a final conclusion and did not rule on this question since the lender had not filed a counterclaim for payment of the margin.

Outlook

While this decision is set to be a leading case on negative interest rates, its precedential value should be considered carefully: the case related to a loan agreement that was entered into, before the financial crisis, in 2006. At that time, negative interest rates were largely unheard of. By 2013, markets had seen instances of negative interest and the Loan Market Association had reviewed its standard agreements to set a floor to the reference rate at 0% or, in other words, ensure that the margin would be payable in all circumstances. Then, by 2015, CHF-LIBOR rates turned negative. It is, therefore, uncertain whether the Court would treat a more recent loan agreement the same way. At the same time, more recent loan agreements are likely to have addressed the issue specifically and, in line with the market standard, floored the reference rate at zero or stipulated that the borrower will pay at least margin.

Furthermore, this decision does not address or impact two other areas affected by negative interest rates: derivatives markets and break costs. Derivatives and, in particular, interest rate swaps are less of an issue. The standard documentation for derivatives explicitly considers and provides for cash-flow inversions when amounts are negative, meaning that a negative interest rate will lead to a payment. Therefore, there is less room for a dispute based on the interpretation of the contract. At the same time, this means that cash and derivative markets handle negative interest rates differently. As a consequence, a borrower who thought to hedge against increases in the reference rate, may end up paying a full margin under the loan as well as the full amount of the negative interest rate under an interest rate swap without any redress, except perhaps in cases of mis-selling.

With regard to break costs in connection with prepayments, most agreements provide, in the event of a prepayment of a loan, for the payment of the margin until the end of the contractual term and allow the bank to collect higher damages it may have suffered. In an isolated case, the District Court of Zurich ruled that the mere existence of a negative reference rate was not sufficient to constitute proof that the bank had incurred a loss in excess of the margin due to the prepayment (ZR 2018 260). This precedent continues to be valid even after the decision of the Swiss Federal Supreme Court.

Overall, this decision brings legal certainty to this issue, which is a good thing since the latest pronouncements of the Swiss National Bank seem to suggest that negative interest rates may be here to stay. At the same time, its impact will be limited to legacy matters, since we would hope that most recent contracts have addressed the matter of negative interest rates explicitly.

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