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Windermere VII Class X Claim Dismissed by High Court

In an important decision of the Financial List of the High Court, on 8 April 2016 Mr Justice Snowden rejected claims by the "Class X" noteholder of the Windermere VII CMBS that it had been underpaid very substantial sums of interest on its notes on interest payment dates in 2015. The judgment in Hayfin Opal Luxco 3 SARL v Windermere VII CMBS plc [2016] EWHC 782 (Ch) has significant implications for other CMBS structures with Class X notes, and for the wider financial markets.

What were the issues raised in relation to the interest payments?

A number of issues were raised in relation to interest payments. Together these had significant implications for who would receive cashflows being generated by the loans underpinning the Windermere VII structure.

1. The EURIBOR element issue

The first issue relates to how interest payable under one of the loans that made up the Windermere VII CMBS was allocated. The "Nordostpark Loan" was divided into senior and junior tranches, with the issuer of the Windermere VII notes holding the senior tranche. The Nordostpark borrower was to pay interest at a fixed rate under the loan comprising two components, a "Fixed Rate" and a "Margin". A swap was entered into in order to swap the Fixed Rate cashflows for floating EURIBOR cashflows.

Three things then happened. The Nordostpark borrower failed to repay the loan at its maturity date in October 2012. A week later the swap expired and was not replaced. And EURIBOR rates had fallen so that the Fixed Rate was much higher than the EURIBOR rate the issuer had been getting under the swap. This meant that the issuer became entitled to higher cashflows from the Nordostpark Loan than before (although the Nordostpark borrower could not actually pay).

An intercreditor agreement between the issuer and the junior lenders determined how the cashflows under the Nordostpark Loan and the swap (if still in place) should be shared. Both pre- and post-default it provided for them to share the Margin element according to a formula, and to each to take a proportionate share of the EURIBOR element.

This had made sense when the swap was converting the Nordostpark Loan cashflows into EURIBOR. But once the swap fell away it meant the loan was accruing much larger fixed interest amounts, but the interest due to the issuer was based on the lower EURIBOR rate. The rights to the surplus were "trapped" in the loan structure.

This was particularly relevant to the Windermere VII's "Class X" noteholder. As explained in my recent Q&A on the Titan Class X claims, Class X notes are a means of paying to the originator of a CMBS any "excess spread" between the cashflows generated by the underlying loans and the interest amounts payable on all the other classes of notes. If the Nordostpark Loan interest was at the higher Fixed Rate there would be more of an excess spread.

The Class X noteholder asked the court to "correct" the intercreditor agreement by implying words or construing the provisions so that the interest rate payable to the issuer should include EURIBOR where a swap remained in place, or the Fixed Rate (if higher) where there was no swap (after a default).

2.The default interest issue

The second issue was whether if default interest became due on the Nordostpark loan following repayment default that increased the Class X interest rate.

That question hinged on an apparently contradictory definition in the Windermere VII note conditions. The Class X interest amount was calculated by deducting the "Expected Available Interest Collections" on the underlying loans from the interest payable on all the other classes of notes besides Class X. The Expected Available Interest Collections can be paraphrased as the amounts actually received by the Issuer into a transaction account. But the Expected Available Interest Collections were stated to assume "full and timely payment…of interest due and payable on the…Loans".

The Class X noteholder argued that the assumption that interest had been paid in full applied to any default interest, so increasing the excess spread. The Issuer argued that the key question was what had in fact been paid into the transaction account.

3. The servicing fees issue

On a related issue, the court was also asked whether the payment of servicing fees relating to the Nordostpark Loan reduced the Expected Available Interest Collections and therefore the Class X interest rate otherwise payable.

4. The capitalization issue

The fourth issue related to the loan servicer's decision to capitalize interest on another underlying loan, the "Adductor Loan". That loan agreement allowed unpaid interest to be rolled up into the principal once the interest had gone unpaid for a year. Rolled up interest was excluded from the Expected Available Interest Collections, reducing the Class X interest amount. The court was asked whether this was correct.

5. The interest on unpaid interest issue

The last interest issue was whether underpaid Class X interest amounts accrued interest at the Class X interest rate, or some lower rate.

Why was it claimed that there was an underpayment and that it amounted to an event of default?

The Class X noteholder argued that if it was right on any of its underpayment claims then there had been an event of default under the Windermere VII note conditions. Condition 10(a)(i) of the notes made it an event of default to fail to pay due interest for five days on the most senior class of notes then outstanding. By October 2015 the Class X notes were the most senior class still outstanding.

What did the judge rule in the case?

1. EURIBOR element:

The court reviewed recent Supreme Court case law on contractual interpretation as it applied to tradable financial instruments. It concluded that there "is a premium to be placed on the language actually used in the instrument" in such contexts. There was no basis to add to the wording of the agreements or construe carefully negotiated provisions contrary to their natural meaning to address issues that must have been foreseeable to the parties at the outset.

2. Default interest:

The court preferred the issuer's interpretation of the Expected Available Interest Collections definition. It considered that the post-default waterfall of the intercreditor agreement subordinated default interest to unpaid interest and principal on both the senior and junior loans, so even if default interest was assumed to have been paid in full, it would not find its way to the transaction account and should not therefore be counted as part of Expected Available Interest Collections.

3. Servicing fees:

The court decided on the same basis that the payment of servicing fees relating to the Nordostpark Loan reduced the Expected Available Interest Collections and therefore the Class X interest rate otherwise payable. The amount of the fees came out of the post-default payment waterfall under the intercreditor agreement before any sums were available for transfer to the transaction account and payment of interest under the Class X notes.

4. Capitalization:

The court decided the issuer had been right not to treat capitalized interest as interest falling within Expected Available Interest Collections. It noted that the ability to capitalize interest in this way had been built into the loan agreement, and therefore noteholders knew it to be an option open to the servicer provided it was consistent with the "servicing standard". On a straightforward reading of the Expected Available Interest Collections definition and related terms in the note conditions, capitalized sums were no longer interest. It would have been easy to have drafted the terms to treat them as such, but the draftsman had not done so.

5. Interest on interest:

The way the other issues had been decided made this issue moot, but the parties asked the court to express a view anyway, given the significance to the wider market. With some hesitation the court held that the correct interpretation of the note conditions did not require payment of interest at the Class X interest rate on any underpaid Class X interest amounts.

Provisions dealing with known underpayment of Class X interest due to shortfalls in proceeds available to the issuer did not apply to mistaken underpayments. Further, because it was for the cash manager to determine the Class X interest amount, any amount not so determined was not due, and could not therefore accrue interest.

The court rejected an alternative argument by the issuer that the note conditions should be construed on the basis that the parties could not have intended the Class X interest rate to apply to underpaid Class X interest amounts. But the court was inclined to accept that a requirement to pay interest at the Class X interest rate on underpaid sums would be void as a penalty clause, applying the recent Supreme Court authority of *Cavendish Square Holdings v Makdessi*.

Note event of default

Again, this issue was moot because there had been no underpayment. The court expressed the view that even if there had been, it did not amount to an event of default under the notes. The reasoning was that no unpaid sum had been determined by the cash manager to be due. The court considered this outcome to be commercially more sensible than having a "hair trigger" in the structure whereby an innocent miscalculation could cause a note event of default, with hugely significant consequences for all parties.

What can practitioners take away from this decision?

Some aspects of the court's finding will inevitably be specific to the peculiar circumstances of the Nordostpark loan default and the precise terms of the Windermere VII structure and underlying loan documentation.

But some of the findings will be relevant to comparable structures where the same issues are known to exist. For example, the court's findings on the default interest issue and the question of whether the Class X interest rate applies to underpaid Class X interest amounts were both before the court in the Titan Class X cases recently tried before the High Court. The finding that underpaid interest sums are not due absent a determination by the cash manager is striking. So too is the indication that applying the Class X interest rate to underpaid Class X interest amounts may be an unenforceable penalty clause.

The court's application of important recent Supreme Court decisions to a structured finance context is of wider significance and justifies careful consideration. This is one of the early decisions of the new Financial List division of the High Court, which was set up in October 2015. It contributes to a growing body of case law that suggests this specialist financial court is developing a specialist approach to interpreting financial agreements that is sensitive to their unique financial markets context.

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