SQUIRE PATTON BOGGS

Structured Finance in the Courts: Five Things We Learned From the Class X Cases

As regular readers of our finance disputes blog will know, April 2016 saw the High Court in London decide no fewer than five cases brought by the holders of Class X notes in 2006 and 2007 vintage CMBS structures. With the judgments in *Hayfin Opal Luxco 3 SARL v Windermere VII CMBS plc* and *Credit Suisse Asset Management LLC v Titan Europe 2006-1 PLC and others* bringing to an end the latest phase in the controversy surrounding Class X, it is a good time to reflect on what they mean for the market.

Still No Consistency in the High Court

For years now, the increasing complexity and specialization of the structured finance market has been challenging High Court judges. In one 2013 decision, a judge described how as a "simple minded property lawyer" he found a CMBS transaction "Byzantine in the extreme". Part of the problem was that, as the same judge put it, "there are no special principles that apply to these contracts as regards construction". That generalist approach was applied by generalist judges from all walks of the bar, deciding cases while grappling with finance structures, sometimes for the first time in their careers. Erratic decisions sometimes ensued.

To restore the English courts' reputation as a centre of excellence for finance disputes, in 2015, a specialist "Financial List" was set up, with complex finance cases to be heard by specially selected judges with appropriate training and experience. The Windermere judgment by Mr Justice Snowden was the fifth decision emanating from this specialist List. The Titan cases were not transferred onto the List, but were heard by the Chancellor of the High Court, Sir Terence Etherton, who is one of the List judges. For two judgments on very similar issues decided by judges of the same sub-division of the High Court within weeks of one another, the differences are striking.

For example, it was claimed in both cases that the right to default interest under the underlying loans should increase the Class X interest rate. In Windermere, that claim failed on a close textual analysis of the definition of the "Expected Available Interest Collections", leading to the conclusion that since default interest was not in fact flowing into the transaction account, it should not be counted. In Titan, the text is glossed over to focus instead on whether the parties could have intended the commercial consequences of the position taken by the Class X noteholder.

The question of what interest rate applied to Class X interest that had been underpaid was made moot in both cases by other aspects of the decisions. But in Windermere, the issue was analyzed in detail anyway; whereas in Titan, the court refused to give any guidance at all.

While the overall outcome went the same way in both judgments, the contrasting approaches make it difficult for the market to interpret the decisions and learn lessons for the future. Despite the best intentions behind the Financial List, there is clearly some way to go before the financial community can be confident of consistent decision-making before the High Court.

A Tailored Approach to Interpreting Finance Agreements, But Which One?

The two judgments even show differing approaches to the basic question of how to interpret the agreements before the courts.

In Windermere, the judge applied a bespoke approach to interpreting structured finance agreements. He said that there was "a premium to be placed on the language actually used" in cases concerning tradeable financial instruments, indirectly citing the Supreme Court decision in *Re Sigma Finance Corporation*. He reasoned that where notes were being traded, it was important not to take into account background facts not necessarily known to secondary investors.

While *Re Sigma* was cited in the Titan judgment, it was used as an authority for avoiding an "over-literal interpretation" that might "distort or frustrate the commercial purpose" of the deal. The reasoning was that the complexity of the documents comprising the Titan CMBS deals was bound to give rise to "ambiguities, infelicities and inconsistencies".

So both judges were alive to the unique features of structured finance agreements and sought to tailor their approach to that context, but in contrasting ways. Appellate clarity may be needed as to which judge did so correctly. In recent years, the Court of Appeal has generally been more purposive in its approach to complex finance cases, but it remains to be seen if that will still be its leaning post-*Arnold v Britton.*

The High Court Trend Is Still "Pro-senior" in Inter-creditor Disputes

The overall impression from reading both decisions is that the judges instinctively disliked the idea that the Class X noteholders should reap further windfalls from CMBS structures that had performed so badly for the regular classes of noteholder. Both seem to have set out in search of a way to reject the claims; although they found contrasting solutions, which were convincing to differing degrees.

Class X is not really "junior" in the usual sense. But if the claims are viewed as a grab for money otherwise destined for the senior classes of conventional notes, then arguably, the results and the manner in which they were reached fit with the general trend in inter-creditor structured finance disputes of recent years. Court decisions like those in the 2013 Theatre CMBS case, the 2015 ruling on DECO 15 and the 2014 ruling on Titan 2007-1 all represent, more or less, part of a tendency of the High Court to side with senior and/or against junior creditors in complex, finely balanced matters of interpretation of structured finance document suites. This trend continues despite the Supreme Court's more literalist approach in its 2015 decision in *Arnold v Britton*.

Of course, correlation is not causation. Whether the trend reflects wariness of junior creditors overreaching the commercial sense of the agreements for their own ends, a pro-senior leaning in the drafting of the agreements or just coincidence will remain up for debate as further cases come before the courts.

Structured Finance Is Prone to Attacks Using General Legal Principles

As noted above, the current answer to the question of what specialized principles for interpreting structured finance agreements are emerging is likely to depend upon which judge you ask. But either way, it is clear that basic principles of English contract law do still apply, with potentially significant consequences.

For example, Mr Justice Snowden said he was inclined to find that applying the Class X interest rate to underpaid sums would be an unenforceable penalty clause, applying recent Supreme Court authority from *Cavendish Square Holdings v Makdessi.* That inclination was moot because of other findings. But it was a marker that the courts would be willing to strike down contractual terms on policy grounds in appropriate cases.

Creative attempts to use general legal principles to challenge aspects of securitization structures have met with mixed success in the past. In one example, the courts in the Fixed Link Finance litigation in 2007 rejected out of hand the suggestion that note controlling party provisions constituted a derogation from the minimum requirements of an English law trust. The Windermere judgment might lead to renewed use of such collateral attacks on the drafting of agreements.

Uncertainty Until 2017

It can be seen that these two judgments have created as many questions as they have answered. While the prospects for Class X claims look unpromising barring clearly drafted documents, uncertainty in the courts' approach will probably encourage other claims. The Windermere judgment is under appeal, but the ongoing logjam in the Court of Appeal lists means it will be March 2017 before it is heard. Until then, these two contrasting judgments will stand as the latest statement of the law in the area.

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