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Class X Litigation: A Review of the Recent Windermere VII and Titan Judgments

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Introduction

March and April of this year were busy months for Class X disputes relating to legacy CMBS transactions. On 8 April 2016, judgment was handed down by Mr Justice Snowden in relation to the claim brought by the holder of the Class X Notes issued by Windermere VII CMBS PLC[1] and on 28 April 2016 the Chancellor of the High Court, Terence Etherton, handed down judgment in respect of four consolidated claims relating to the Class X Notes issued by Titan Europe 2006-1 P.L.C., Titan Europe 2006-2 P.L.C., Cornerstone Titan 2007-1 P.L.C., and Titan Europe 2007-2 P.L.C. [2].

These judgments vindicate the intended economics of the Class X structure. They provide comfort for investors that the Class X Note works as it was designed to do. The Courts have shown that they will look to the intention of the relevant parties when the transaction was entered into and the purpose of the Class X Note rather than allow Class X Noteholders to benefit from the relevant transactions in ways the parties never intended.

Background to Class X Claims

Class X Notes may have acquired a certain notoriety following the credit crunch and the difficulties in the European commercial real estate market. However, initially the structural intent of the Class X Note garnered little question or criticism.

The intent of the Class X Note in a CMBS structure is to create a tradable instrument which extracts *"excess spread"* being, in summary, the difference between the aggregate interest accruing on the underlying loan pool less the aggregate of the total interest payable on the other classes of Notes and the operating expenses of the CMBS. The Class X Note was often retained by the bank arranging the CMBS transaction and they were a widespread structural feature of CMBS transactions.

During the period whilst CMBS transactions were performing there was little overt criticism of Class X Notes. Contention has arisen in situations where the underlying loans stopped performing and

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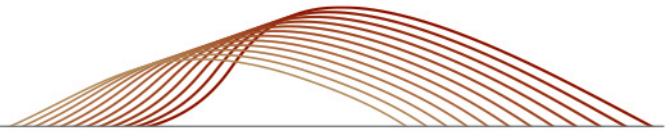
[1] [2016] EWHC 782 (Ch) http://www.bailii.org/cgi-bin/format.cgi?doc=/ew/cases/EWHC/Ch/2016/782.html&query=(WINDERMERE)

[2] [2016] EWHC 969 (Ch) http://www.bailii.org/ew/cases/EWHC/Ch/2016/969.html



other classes of Notes suffered losses while the Class X Notes, often retained by the bank that arranged the relevant transaction, were continuing to receive substantial payments.

Investor criticism has often focused on the question of what monies should form part of *"excess spread"*. The excess spread concept for Class X Notes issued under a number of CMBS transactions relates to the interest payable rather than actually received on the underlying loan. This concept existed with all classes of notes; payments were to be based on interest accrued on the notes rather than interest actually realised on the loans. In the situation where the Class X Notes were rated, this so called *"current pay"* would have been a requirement of rating a series.

Below we consider the differences to be found in the calculation of Class X interest under the Windermere VII and Titan transactions.

Windermere VII

The Windermere VII transaction involved the issuance of eight tranches of Notes on 16 May 2006 by Windermere VII CMBS PLC in an aggregate nominal amount of €782,500,000. The Note proceeds (other than those from the Class X Notes) were utilised to purchase a portfolio of 16 loans/loan tranches secured by properties in Germany, Sweden, France, and Spain. The Class X Note was originally retained by Lehman Brothers as the arranger of Windermere VII.

As was typical with Class X structures, it was anticipated that the Class X interest would be determined by reference to the excess *"Expected Available Interest Collections"* (in summary all sums expected to be received in respect of interest for a particular period) over the aggregate of the administrative costs, fees, and expenses of the transaction and the interest payable on each class of Notes other than the Class X Note.

Titan Transactions

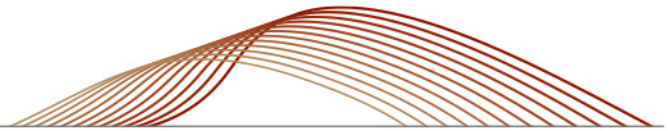
The four Titan transactions in question were each multi-loan securitisations. Across the four transactions the securitised loans were secured by properties in Germany, France, Switzerland, Poland, the Netherlands, Finland, and the Czech Republic.

The calculation of the amount to be paid on the Class X Notes under the Titan transactions is broadly the same for each transaction and is more involved than for the Windermere VII transaction. In brief, the amount is determined by utilising an interest rate calculated by a comparison of the average coupon on the Notes as compared to the comparative average coupon on the loans, taking into account and attributing on a pro rata basis to each securitised loan, the ordinary expenses that accrue at the securitisation level. As with the Windermere VII transaction, excess spread is calculated on the basis of amounts due on the securitised loans rather than amounts actually collected.

Windermere VII

The issues raised by the Class X Noteholder mainly concern interpretation of the transaction documentation and revolve around the correct computation of payments to be made to the Class X Noteholder on two quarterly interest payment dates. Some of the most interesting points to emerge are outlined below:

- The Class X Noteholder asked the Judge to rule that the definitions of "*Senior Rate*" and *"Junior Rate"* in a loan level inter-creditor agreement should be interpreted in such a way (or a term implied into the agreement) so that, in circumstances where there is no swap in place, the amounts payable into the Issuer's *"Transaction Account"* are not calculated using EURIBOR but using the (much higher) fixed rate payable by the relevant borrower under the loan agreement. Given that the interest payable on the regular Notes is



computed using EURIBOR, such increased payment would give rise to a substantial excess, which would benefit the Class X Notes.

- The Judge concluded that the test that must be satisfied to justify supplying additional language or terms to a contract is a strict one and one that the Class X Noteholder had not met. He stated that the Court will not supply additional words or terms to a contract simply because it is reasonable to do so in the circumstances. The Court will only add words to the express terms of an agreement if it is necessary to do so because the agreement is incomplete or commercially incoherent without them. Even then, the Court must be certain both that the absence of the missing words was inadvertent, and that if the omission had been drawn to the attention of the parties at the time of contracting, they would have agreed on what additional provisions should have been made.

- On a separate point, the Judge determined that the Issuer had been correct to reduce the amount of the Expected Available Interest Collections to take into account the capitalisation of interest. The main reason given was that the ability to capitalise unpaid interest after one year was built into the relevant underlying loan agreement and the Noteholders must therefore have envisaged that such power was available. If it had been intended that such capitalisation should not have the result of reducing the amount of the Expected Available Interest Collections, or that the computation of such amount should disregard any capitalisation of interest that could and should have been spelled out in the documents.

- The Judge also determined that any historic unpaid Class X interest should not accrue interest at the Class X Rate. The Class X Rate is determined after the actual Class Interest Amount is calculated. The Class X Notes were given very low principal balances, typically €50,000, and the interest rate was determined by dividing the interest payment by the low principal balance of the Class X Notes. The calculation would result in a very high interest rate, which was really just used for reporting purposes in the transaction. The Judge stated he did not believe that the Class X Interest Rate as defined in the Conditions could correctly be characterised as a rate of *"interest"*, given that it could not be calculated until after the Class X Interest Amount had been determined. Further, if such interest were to accrue at the Class X Interest Rate, then the almost inevitable result, which was foreseeable at the time of contract, would be an *"exorbitant (if not extortionate)"* interest payment many times the amount that would adequately compensate the innocent party for being kept out of its money. While he did not have to decide the matter, the Judge said that he was *"inclined to agree"* with the Issuer that such a rate would in any case be invalid as penalty.

- The Judge was clear that there was no underpayment. He also agreed with counsel for the Issuer that even if there had been a miscalculation and underpayment of the Class X Interest Amount, it would not have been an Event of Default in respect of the Notes. Given the hugely significant consequences for all parties of a Note Event of Default, he did not believe that the parties intended to create such a *"hair trigger"*, under which an Event of Default could occur because of a miscalculation, and then be incapable of cure at a later date.

Analysis of Titan Claims

The hearing of the claims of the holder of the Class X Notes issued by Titan Europe 2006-1 P.L.C., Titan Europe 2006-2 P.L.C., Cornerstone Titan 2007-1 P.L.C., and Titan Europe 2007-2 Limited took place between 7 and 15 April 2016. The Titan claims are more limited than the Windermere VII claims and in determining what is to be characterised as excess spread largely relate to

whether the relevant interest rates include default interest. Judgment was handed down on 28 April 2016 and we outline some key points in the judgment below.

- The Chancellor determined that when calculating the Class X Interest Rate, no account should be taken of additional interest following a default. In giving his reasoning the Judge stated:

> the effect of including default interest in the calculation of the "Net Mortgage Rate" is that the worse the Loans perform the higher proportion of the Loan income is payable to the Class X Noteholder. That is counter-intuitive bearing in mind that the Class X Notes represent the financial reward to the Originator of the structured note offering, which was intended to attract investors on the basis that the Loans were sound and shown to be such by favourable Moody's ratings for the Notes. .. The point is also given added weight by the fact that, in contrast to the subscribers for the Class A-H Notes, the Originator paid the relatively insignificant sum of €50,000 for the Class X Notes, none of which was at the risk of non-performance of the Loans: that sum was placed in a separate account, €45,000 was re-payable (and was duly paid) on the first payment date and the Class X Interest Rate was based on the interest rates payable under the Loans rather than what was actually paid under them.

He also referenced the point that the Offering Circular contained no indication that the Class X Notes would factor in default interest if it became payable.

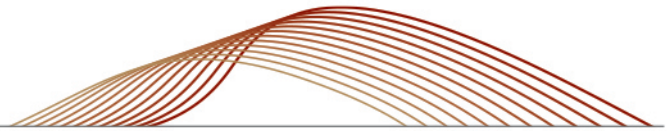
- The Class X Noteholder argued that the Class X Notes should remain outstanding (and interest should continue to be payable on them) until all other Notes have been redeemed. This argument was on the basis that there has to be a Class X Noteholder to receive the difference between the amount due on the Loans and the interest payable on outstanding A-H Notes to prevent an excess being accumulated by the Issuer, which was not the intention of the structure. The Chancellor ruled against the Class X Noteholder. He said that the interpretation of the documents that the Class X Noteholder was asking him to make:

> would mean that, even though (1) the Originator never risked any capital for the purchase and subsequent non-performance of the Loans, (2) its outlay was limited to a mere €50,000, (3) that sum was placed in a separate account reserved for its repayment, (4) €45,000 was repaid on the first Payment Date, and (5) the remaining €5,000 is available for redemption of the Class X Notes, nevertheless the Class X Notes would remain in existence for an indefinite period creaming off payments from the borrowers to meet the Class X Noteholders' entitlement at the top of the waterfall, an entitlement which is proportionately higher than it would have been if there had been no default under the Loans.

Conclusion

Cases such as the ones discussed above provide a backdrop for the recent *"fixes"* to the Class X Notes seen in CMBS 2.0 transactions. The chief complaint that the CMBS 2.0 transactions have addressed is the assertion that the CMBS 1.0 offering documents contained insufficient disclosure around the Class X Note and its calculation and payment mechanics. CMBS 2.0 offering documents seek to ensure that there is clear and concise disclosure on: the ranking of the Class X Notes; the role of any liquidity facility; how excess spread is calculated and who is entitled to receive such amounts. CMBS 2.0 transactions also generally ensure that the calculation of interest on the Class X specifically ignores default or modified interest.

Leave to appeal has been granted in respect of the Windermere VII judgment, but refused in respect of the Titan judgments. It remains to be seen how this litigation and the Class X Note itself



will develop, but for now the Windermere VII and Titan cases should ring a warning bell for Class X Noteholders seeking to obtain economics not originally intended for the Class X Note.

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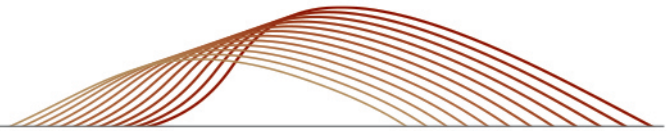

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