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Financial Services Litigation Alert

February 11, 2016

If you read one thing…

- In a very recent decision, the English High Court has provided clear support for the enforceability of a make-whole provision providing compensation to the holders of long-term fixed-rate securities in the event of an early, voluntary partial redemption by the issuer. In sterling fixed-rate note issuances, these make-whole provisions are known as "*Spens*" or "*modified Spens*" clauses.
- Although the outcome of the case turned on the express language of the transaction documentation, two points are of importance to the institutional investor community.
- **First**, the language used in this case is typical in similar English law governed securitisation structures.
  Second, the Judge in the case readily accepted the commercial common sense in holders of fixed-rate debt, particularly long-dated fixed-rate debt, being protected against opportunistic early redemptions by issuers.

English Court Decision: Canary Wharf Finance II Plc v Deutsche Trustee Company Limited et al.

Introduction

The terms and conditions of long-dated fixed-rate debt securities typically include make-whole provisions that are intended to compensate holders of the securities in the event of voluntary early redemption of the securities by the issuer, as distinct from a scheduled repayment or one that is otherwise mandatory under the terms of the securities. The rationale for these provisions is to offer some protection to investors against opportunistic early redemptions by issuers. That protection is particularly important to holders of fixed-rate debt in circumstances where long-dated debt is issued and market interest rates subsequently fall. Typically, this should result in the yield on the long-dated debt rising, and the cost to an investor of replacing (following an early redemption) the fixed income that would have been earned on that debt also increasing. Investors typically expect to be protected against that risk.

Make-whole provisions included in Sterling fixed-rate bond or note issuances are typically referred to as "*Spens*" or "*modified Spens*" clauses, so named after one of the bankers – Lord Spens – who was involved in the formulation of these provisions for the Sterling bond market in the 1970s. Make-whole provisions require the issuer of the fixed-rate debt to pay an early redemption amount calculated by reference to the present value of the expected future coupons (to the scheduled redemption date) on the bond it wants to redeem. The discount rate used to determine the present value of the expected future coupons is set by reference to the redemption yield of the government debt issuance (for Sterling issues, the reference Gilt) most closely matching the scheduled maturity date of the bond to be redeemed. Depending on the interest rate at the time of the proposed early redemption, the unexpired term of the bond at the time of redemption, and the redemption yields on the reference government bond at that time, this calculation can produce an early redemption amount which is at a premium to the principal amount prepaid plus accrued and unpaid interest. Equally, though, if yields have turned negative, investors are protected by a floor on the early redemption amount of the bonds, at par for the principal amount redeemed, plus accrued and unpaid interest to the date of early redemption.

On 28 January 2016, the English High Court delivered an important decision on whether a Spens clause had been triggered under the terms and conditions of certain commercial mortgage-backed securities (CMBS) issued in connection with the securitisations during the early part of this century of the revenues generated by office buildings in Canary Wharf, London owned by the Canary Wharf Group (“CWG”). The issuer of the CMBS (referred to below as the “Notes”) was Canary Wharf Finance II Plc, a special purpose finance subsidiary of CWG incorporated for the purpose of issuing the Notes (and referred to below as the “Issuer”). The Issuer issued proceedings against Deutsche Trustee Company Limited, as trustee for the holders of the Notes (the “Trustee”) and certain of the holders of the Class A1 Notes, seeking a court declaration as to the proper interpretation of the redemption provisions in the terms and conditions of the Notes, and specifically the Spens clause. The judge at first instance, Mr. Justice Phillips, made an unequivocal finding in favour of the Trustee and the Class A1 Noteholders that the Spens clause had been triggered and accordingly entitled the Class A1 Noteholders to receive a premium on the partial prepayment of their Notes. The judge’s findings were based on the interpretation of the relevant contractual provisions, on the commercial sense of those provisions, and on the transaction as a whole.

Background facts

Under the securitisation structure, the Issuer issued, over a number of years, multiple classes of Notes, both fixed-rate and floating-rate. It applied the proceeds of the Notes it had issued in making loans to another special purpose CWG company, CW Lending II Limited (the “Borrower”). These loans were documented under an Intercompany Loan Agreement (the “ICLA”), with the terms of each loan substantially replicating the commercial terms of the corresponding class of Notes; thus, for example, the proceeds of the Class A1 Notes issued by the Issuer were applied in making an “A1 Loan” to the Borrower. The Borrower then on-lent the sums received from the Issuer to further special purpose entities in CWG, each of which owned an office building on the Canary Wharf estate (each, a “Propco”). The Borrower’s liabilities to the Issuer under the ICLA were secured by, among other things, legal charges (mortgages) over the Propcos’ properties.

In the period leading up to June 2014, CWG decided that it would be commercially desirable to sell the freehold interest in 10 Upper Bank Street (known as “HQ5”), one of the properties in the securitised portfolio.

In June 2014, HQ5 was sold for £795 million. Under the terms of the ICLA, the Borrower repaid £577.9 million to the Issuer by way of a partial prepayment under its A1 Loan, and the mortgage and other security interests over HQ5 were released accordingly. On 22 July 2014, the Issuer purported to utilise that sum to effect a partial early redemption of the fixed-rate Class A1 Notes, but on the basis that the Spens clause in the terms and conditions of the Notes did not apply. The interest rate on the Class A1 Notes is 6.455 per cent. per annum, and the legal final maturity date of the Class A1 Notes is October, 2033; so the Notes were being partially redeemed almost 20 years before their scheduled redemption date, in a low interest rate environment.

The dispute

The question arose as to whether the Issuer could partially redeem the Class A1 Notes ahead of their scheduled maturity date, using funds received from the Borrower following a voluntary sale of HQ5, without paying the Class A1 Noteholders a make-whole amount. The terms and conditions of the Notes (the "Conditions") contain a Spens clause which is expressed to be applicable in specified circumstances in which fixed-rate Notes are subject to an early redemption, including an optional redemption by the Issuer. The Issuer contended that the prepayment made on the Notes as a consequence of the sale of HQ5 was a mandatory prepayment under the Conditions, not an optional prepayment and, therefore, the Spens clause did not apply. After attempts to settle the dispute out of court failed, the Issuer commenced proceedings before the High Court in England seeking a ruling as to whether, on a proper construction of the Conditions, the redemption of the Class A1 Notes effected in July 2014 constituted a "mandatory repayment" or an "optional redemption". An optional redemption would require the Issuer to pay the Class A1 Noteholders a premium of £168,746,800. The Issuer had agreed, before the court proceedings were issued, to deposit this sum into a bank account charged in favour of the Trustee, pending the resolution of the dispute.

The court's findings

Mr. Justice Phillips found that the language of the disputed provisions in both the Conditions and the ICLA was "*clear and unambiguous*" and, accordingly, that the prepayment of the Notes was voluntary, resulting in the *Spens* clause being triggered. In making his findings, Mr. Justice Phillips rejected all of the arguments on interpretation put forward by the Issuer under various provisions of the Conditions and the ICLA.

The Issuer's central but unsuccessful argument appears to have run as follows. Even though the decision by CWG to sell HQ5 may have been voluntary, some of the consequences that flowed from that decision under the ICLA and the Conditions were mandatory. More specifically, where, following that sale, the Borrower elected to obtain a release of the mortgaged property, that release entailed a *mandatory* partial prepayment of the intercompany loan (the A1 Loan) which would be used to effect the partial early redemption of the Class A1 Notes; thus, the Issuer argued, avoiding the requirement for a *Spens* payment that would have arisen if that partial prepayment had been voluntary.

In the judge's view, however, the language used in the ICLA and the Conditions did not support this argument. In his words: "The immediate difficulty with that contention is that [*the disputed language*] plainly does not impose any obligation on the Borrower to make a prepayment…" The judge then went on to compare the language used in other clauses of the ICLA that did impose mandatory obligations. This language plainly had mandatory characteristics, for example, requiring that the Borrower "*shall repay the Loans in full…*" if the transaction becomes illegal. By contrast, in the judge's view, the disputed language contained no imperative as it was stated to apply "*…if….the Borrower makes a prepayment…*"

Having decided the question of interpretation on the basis of language which Mr. Justice Phillips considered to be plain and unambiguous, the judge did not need to consider the arguments submitted by both parties with regard to construing the language in the Conditions and the ICLA in accordance with commercial common sense. Nevertheless, he went on to consider these arguments in order to reinforce his reasoning, and perhaps make his decision more difficult to appeal successfully.

In the judge's view, the purpose of the CMBS issuances was to provide long-term finance to the CWG against the security of its real property whilst providing the holders of Class A1 Notes (although the same arguments would apply to all holders of fixed-rate Notes in the securitisation structure) a fixed-rate of return over the same period. The structure would, in his view, be nonsensical and the benefit to the Noteholders undermined (and therefore the viability of the securitisation itself) if the Notes could be redeemed at par at any time. Mr. Justice Phillips went on to state that "*It is therefore not in the least surprising that the ICLA and the Conditions make provision to ensure that the holders of long-dated Fixed-Rate Notes cannot be deprived of the long-term value of their investment without being fully compensated (or even over-compensated) at the expense of the CW Group….*".

The Noteholders, for their part, argued that there was a clear distinction between the circumstances in which a redemption premium was payable and those where it was not—a premium was usually payable where a prepayment of the debt resulted from matters within CWG's control or where CWG was at fault. Where a prepayment was outside CWG's control, no premium would be expected. Mr. Justice Phillips agreed with this rationale. The decision to obtain a release of HQ5 from the security interests was entirely within the control of CWG.

Consequently, Mr. Justice Phillips made a declaration that the amount of £168,746,800 plus accrued interest was payable to the Class A1 Noteholders.

The Issuer issued a press release dated the date of the judgment in which it stated that it was "disappointed" by the High Court's decision, and that it will be applying for permission to appeal the decision.

Akin Gump commentary

The case represents an important victory for the Class A1 Noteholders concerned. Although the outcome turned on the particular language used in the ICLA and the Conditions, that language was typical of similar language used in other U.K. CMBS structures by which other U.K. commercial property companies and REITs have secured long-term funding. It is also typical of prepayment provisions included in other long-dated debt documentation, including PFI debt and project financings. Moreover, the ready acceptance by the judge that it is commercial common sense for the interests of holders of fixed-rate debt, particularly long-dated fixed-rate debt, to be protected against opportunistic early redemptions by issuers, provides some comfort to all institutional investors.

For EU insurance companies who are subject to Solvency II, this decision is also important in the context of their ability to make use of the “matching adjustment” provisions in Solvency II in order to reduce capital charges. Any uncertainty as to the circumstances in which a make-whole provision may be triggered may have consequences in terms of the eligibility of assets for the matching adjustment.

It is worth noting that this case did not produce new law on how to interpret commercial agreements. There has been a string of decisions from the senior English courts over recent years on the rules to be applied by the courts when interpreting contracts; and in this case, those rules were not in dispute. Clients should note that the English court’s starting point in construing provisions in an English law contract will always be the express terms of those provisions; the court has said on numerous occasions that it is not for the court to rewrite a contract *ex post facto* because one party decides that an outcome under the contract was not what it had wanted. In this regard, we would note that, for those clients who are interested in or involved in the cross-border private placement market, the U.S. Model Form X-1 and X-2 Private Placement Note Purchase Agreements expressly provide for a number of circumstances in which a make-whole amount may be payable on a full or partial early redemption of the notes issued under those agreements. These circumstances expressly include, among others, an obligation to pay a make-whole amount (if the present value calculation described above produces a positive number) to the noteholders if the notes are accelerated upon or following the occurrence of an event of default. (This approach may be contrasted with the English law form private placement documents prepared by the Loan Market Association, in which the concept of a make-whole amount is left to be determined on a transaction-by-transaction basis.)

There have been a number of recent decisions in the U.S. bankruptcy courts in Delaware and New York on the subject of an investor’s right to a make-whole payment should its debtor enter a U.S. bankruptcy proceeding. While the detail of those cases is beyond the scope of this note, it is, again, worth noting that the outcomes in those cases have largely depended on the express provisions of the debt instrument or trust indenture under which the relevant notes were issued. In at least one case, the trust indenture under which the notes were issued did not provide for a make-whole payment to apply following an automatic acceleration of the notes upon the issuer’s bankruptcy; the indenture trustee was unsuccessful in its arguments before the bankruptcy court in attempting to obtain a make-whole payment. The lesson to be learned, therefore, for both English law debt documentation and U.S. law debt documentation, is that the express language used in the drafting of make-whole provisions is critical.

As noted above, the Issuer has already stated that it intends to appeal this decision. The right to appeal is not automatic and the Issuer will need permission from the Court of Appeal. If an appeal is pursued, it is unlikely to be heard for many months.

The litigation and institutional finance teams at Akin Gump will continue to monitor this case and provide a further update if there are material developments.

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