

In Practice

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Contractual v commercial reality

This In Practice article considers two recent cases concerning contractual disputes involving Servicing Agreements in CMBS transactions.

INTRODUCTION

In the post-Lehman world, the majority of English law cases in the financial arena are still contractual disputes. They remain the bedrock of any litigation practice.

In construing financial transaction documents, the English court has recently had to grapple with a particular dilemma. An English law contract must be construed in order to discover the objective intention of the parties, which is to be found by adopting “the meaning which the document would convey to a reasonable person having all the background knowledge”.¹

The starting point is the words of the contract. But contractual interpretation is an “iterative process”;² it does not begin and end with the words on the page. The court will assess the meaning of those words in their commercial context. Any ambiguity will be resolved in favour of the construction that is “consistent with business common sense”.

The dilemma that the court often faces is that a literal interpretation of a contract may suggest one interpretation, but the commercial context of purpose to the contract suggests another. So how is that dilemma to be addressed?

We examine two cases below, involving the interpretation of Servicing Agreements in two CMBS transactions. The issue, in both cases, related to the replacement of a Special Servicer, which plays an important role in such transactions, with particular responsibilities if the transaction falls into some form of distress. The principal question was whether it could be replaced where each of the Rating Agents, namely Moody’s, Fitch and Standard & Poors, had not endorsed its replacement.

TITAN (NHP)³

In this case, the Agreement provided for a replacement of the Special Servicer, but only where “the Rating Agencies shall have confirmed that the appointment of the successor ... Special Servicer ... will not result in an Adverse Rating Event”. The difficulty was that Fitch announced, in December 2012, that it would not, as a matter of policy, provide such confirmations.⁴

The Class A Noteholders argued that Fitch’s failure to provide the confirmation meant that the condition to the replacement had not been met. The holders of the subordinated Class E Notes disagreed. They were keen to terminate the appointment of the then current Special Servicer, as its

proposals would have left them “underwater”. They argued that the confirmation from Fitch was not a strict condition and, in support, pointed to an analogous, albeit unrelated, clause in the Servicing Agreement, which provided that, if a Rating Agency declined to issue a requisite written confirmation, then “the ... provision shall be read and construed as though written confirmation ... is not required”.

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The Judge agreed with the Class E Noteholders. He found that the analogous clause was a clear indication of the intention of the parties in the event that a Rating Agency stopped issuing confirmations altogether. He was also influenced by broader commercial considerations too; stating that:

“I cannot see how it would make any commercial sense for the parties to have agreed that ... just because Fitch no longer gave rating confirmations as a matter of policy, the ... Special Servicer could not even validly terminate its own appointment.”

DECO 15⁵

This case turned upon similar facts. As in *Titan (NHP)*, the Agreement provided that a Special Servicer could not be replaced unless “the Rating Agencies have confirmed ... that the appointment of the successor ... Special Servicer ... will not result in an Adverse Rating Event”. As above, Fitch had indicated that, in accordance with its policy, it would not issue a confirmation.

There were, however, important differences in the documentation and, as such, the Judge did not consider himself bound by the analysis in *Titan (NHP)*. For example, unlike in *Titan (NHP)*, there was no indication of the intention of the parties if every Rating Agent ceased to provide confirmations. In *Deco 15*, the draftsman had only considered the possibility that Moody’s may not provide a confirmation.

Contrary to the Judgment in *Titan (NHP)*, the Judge found that, as a matter of language, each and every Rating Agency

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must provide a confirmation for the Special Servicer to be replaced. The language was unambiguous, and so should be strictly followed.

Despite there being no ambiguity, the Judge also looked at commercial considerations and whether the strict interpretation of the condition would frustrate the replacement of the Special Servicer. In *Deco 15*, the Judge was able to identify a partial answer to these issues since the Agreement provided for alternative means to appoint a successor Special Servicer, namely where “each class of Noteholder has approved the successor ... by Extraordinary Resolution”. There was, therefore, no need depart from the natural meaning of the condition.

CONCLUSION

There is no one size fits all, in relation to the interpretation of financial documents.

Arguably, a broader, commercial approach was adopted in *Titan (NHP)*, whereas *Deco 15* perhaps focussed more on the natural language of the key clauses. But any difference in approach is best explained by the fact that there were material differences in the

transaction documents. It was those differences too, which enabled each Judge to address the commercial implications of their decision, and to avoid any argument that their views were not consistent with commercial reality. ■

- 1 *Investors Compensation Scheme Limited v West Bromwich Building Society* [1998] 1 WLR 896.
- 2 *Rainy Sky v Kookmin Bank* [2011] 1 WLR 2900; *US Bank Trustees Limited v Titan Europe 2007-1 (NHP) Limited and others* [2014] EWHC 1189 (Ch); *Arnold v Britton* [2015] UKSC 16.
- 3 *US Bank Trustees Limited v Titan Europe 2007-1 (NHP) Limited and others* [2014] EWHC 1189 (Ch).
- 4 See announcement by Fitch dated 10 December 2012.
- 5 *Deutsche Trustee Company Limited v Cheyne Capital (Management) UK (LLP) and Deco 15 – Pan Europe 6 Limited* [2015] EWHC 2282 (Ch).

Biog box

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