# Chapter 13

# The evolving role of issuers and trustees in CMBS transactions—the epoch of litigation

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## 13.1 Introduction

In 2012, the last edition of this book included a Chapter on the evolving role of issuers and trustees in European CMBS transactions. Such a Chapter would probably not have been considered necessary in the 2006 first edition. At such time, the European CMBS market was a robust and vibrant part of the securitisation industry, with annual issuance volumes continually increasing, both through banks using conduit programmes to securitise the loans they originated and property companies using CMBS structures to refinance their borrowings. The role of the issuer and trustee was considered in quite a different light then and involvement in litigation was not a particular feature.

However, the period between the publication of the first edition and the publication of the second edition was a tumultuous period for the global CMBS market and for its participants. During this period, the GFC occurred, and the market saw a decrease in value (at times, a very significant decrease in value) of the underlying CRE as well as the inability of borrowers to refinance the securitised facilities at maturity. This resulted in the restructuring and/or enforcement of many of the loans underlying CMBS transactions, a subject which was discussed at length in the previous edition of this book.

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This fundamental deterioration in real estate market conditions placed the securitisations under stresses which were not anticipated when the transactions were structured and executed. As a result of these stresses, by the time the second edition of this book was being prepared, the role of various parties in the CMBS market had evolved from those previously envisaged, and often the parties at the forefront of this evolution were those appointed to have an ongoing role in the transaction (such as the issuer, the trustee and the servicer). As such, when the second edition was prepared, it was felt that the evolving role of the trustee and issuer in CMBS transactions warranted further analysis.

The Chapter dealing with the emerging role of issuers and trustees in CMBS transactions considered the position of a trustee and issuer in the pre GFC CMBS transaction as envisaged at closing. It considered a number of issues which had arisen in the years prior to 2012 in the stressed environment of the CMBS market, issues which had direct implications on the role of trustees and issuers in these transactions.

Despite the fact that it has been four years since the last edition of this book, the themes considered in Chapter 10 of the last edition largely remain current, being issues which still arise in legacy CMBS transactions. As such, with a few amendments and updates to the Chapter from the second edition, a new Chapter could have been included in the new edition of this book. However, whilst the issues discussed in the second edition remain relevant at the time of writing, it is considered that a new edition could be used to explore in greater detail one of the themes noted in 2012: the increase in litigation.

Given that CMBS issuers typically issue 10 years paper, the final stages of the life-cycle of CMBS deals (although it is difficult to predict when the life-cycle will be completed for these deals) is in 2016 apparent. A position which for many deals is accompanied by limited and reduced cashflows in the deal. In these types of circumstances, parties start to consider the documentation and their rights under the documents, and as a result, inter-creditor issues and third party claims are, as the second half of 2016 is entered, increasingly becoming common in the CMBS deals which are the subject of this Chapter. Indeed such claims have been gaining momentum since 2014.

Whilst certain of these issues can be dealt with between the parties in a consensual manner, at times this is not possible, and in these circumstances, a party or parties together may seek the adjudication of the court to resolve the issues. As such, for the current edition it has been decided to focus on the involvement of the courts in adjudicating disputes in CMBS transactions—a process with which the trustees and issuers have been necessarily involved.

Of course, seeking the involvement of the courts is generally not the first choice for parties when an issue arises—parties generally will try and consider whether there are consensual ways to resolve the issue. Often this is successful. However, in some cases, the issues in dispute relate to fundamental matters which cannot be addressed without the involvement of the court, or, the positions of various parties are so different that there is no alternative means to resolve the issue.

Experience to date indicates that the involvement of the courts in dealing with the issues that arise in CMBS transactions can rather unscientifically be split into two categories:

(i) Disputes relating to the interpretation of the transaction documents and rights relating to various creditors. For English law transactions, these questions of interpretation are generally dealt with by way of a Part 8 proceeding (which will be considered in further detail below). These proceedings may be brought by the issuer, the trustee or another transaction party (such as a noteholder or liquidity facility provider), and often are brought with agreement by the various parties to the transaction.
(ii) Disputes relating to the action of certain parties which are purely adverse in nature. Examples include professional negligence claims against valuers in CMBS transactions, as well as litigation brought by borrowers against parties to the loans.

Section 13.3 of this Chapter will consider these in further detail through analysis of recent cases. The majority of the discussion will relate to matters considered by the English courts. There will, however, also be some discussion of matters before other courts relating to borrower litigation. It should be noted that references to CMBS transactions in this Chapter are references to CMBS transactions executed pre GFC, and as such should be read as excluding any CMBS transactions issued since 2011.

Before we consider the epoch of litigation in legacy CMBS transactions, we should make sense to remind ourselves of the role of a trustee or an issuer in these deals.

## 13.2 The role of the issuer and trustee in a CMBS transaction

As discussed in the Chapter to the previous edition, neither the issuer nor the trustee is involved in the arranging or structuring of a CMBS transaction, as their role only comes into effect on the closing of the transaction. Prior to that time, neither party has any formal connection with the underlying loans or the originator. Following execution of the transaction, the issuer and trustee (along with the servicer and other agents of the issuer) are the parties whose role continues throughout the life of the transaction and the parties who are required to deal with any issues which arise.

### *13.2.1 The Issuer*

In CMBS transactions (as with most other securitisations), the arranger or originator will appoint a corporate services provider to establish the issuing vehicle (the issuer). Often the corporate services provider is not appointed until the terms of the transaction have been structured and negotiated and the drafting of disclosure documents and legal documents has begun. The issuer will not be involved in negotiating the commercial terms of the transaction (such as representations relating to the assets or the terms of the swaps) nor will it be involved in carrying out due diligence on the portfolio of assets or commissioning reports such as those relating to the valuation of the underlying properties. Rather, it will rely upon the arranger and reports and opinions of the advisers to the arranger (such as legal counsel and accountants).

The corporate services provider will provide directors for the issuer and will also provide company administration and accounting services. The corporate services provider is generally an organisation which provides these services to a number of issuing vehicles and specialises in the structured finance market.

The issuer will be set up as an orphan company. In many common law jurisdictions this means that the shares of the issuer will be held either directly on trust for charitable purposes or by a holding company whose shares will be held on trust for charitable purposes. In other jurisdictions, the orphan structure may be established through the shares being held by a trust or foundation structure (such as the stichting structure in the Netherlands). By this structure, the issuer is not related to the originator or any other party to the transaction. This structure is driven by rating agency requirements which require the issuer to be independent to the originator, established as an orphan vehicle and be bankruptcy remote.

On closing the issuer will issue notes into the capital markets and, with the proceeds of the issuance, the issuer will (i) where the securitisation is refinancing a portfolio of loans originated by a bank, purchase the loans from the originating bank (often the deals are called CMBS conduit deals) or (ii) where the securitisation is refinancing debt of a property company, provide a loan to the property company which will be secured over the underlying assets and may be used by the property company to refinance its existing debt or purchase new assets. A conduit deal may consist of one or a number of loans. As described elsewhere in this book, in conduit deals, the underlying loan will often be tranched, with only the senior tranche (often referred to as the ‘‘A loan’’) being sold to the issuer and securitised.

CMBS transactions were structured on the assumption that throughout the life of the deal the issuer would use the payments it receives on the underlying loans to repay the noteholders (and other creditors) until such time as those parties have been repaid in full. This would either be achieved through the underlying loan repaying principal throughout its life or, more often, being refinanced by the borrower at maturity, with the proceeds of such refinancing being used to repay the loan and redeem the notes accordingly. After repayment in full of its secured liabilities, the issuer would be wound up, and the securitisation would come to an end. At least this was the theory behind these structures. However, as discussed at length in the last edition of this book, events and their effect on the CRE markets have meant that things have not run in quite the way it was assumed they would in 2005–2007.

Sometimes the issuer is seen as merely a conduit to financing or a ''post-box'', with no real position in the transaction other than to act as the issuing entity for the financing. This ignores the legal reality of the issuer—it is a company with directors, who have duties and obligations, as well as liabilities under the company law of the entity's jurisdiction of incorporation. Sometimes an issuer may be seen as solely owing duties to the noteholders. However, this does not accord with the position under English law. Under English company law, as a general principle, the directors owe their obligations to their shareholders rather than their creditors, until such time as the entity is nearing insolvency, at which point their obligations become owed to their creditors. The obligations of the directors under company law can at times place stress on a structure. For example, the directors may have agreed to non-petition language in the documents (which essentially is a provision under which all parties to the transaction agree with the trustee not to petition for the winding-up of the issuer). However, under general company law, there may be a time in the transaction when the directors have a duty to start to wind-up the issuer, irrespective of the position under the documents. It is generally considered that such obligations take precedence to the documents, albeit they are likely to be exercised only on a very limited basis.

### *13.2.2 The Trustee*

The appointment process of a trustee in a securitisation is similar to the process described for the corporate services provider. The trustee may be the corporate trust entity of a financial institution or it may be a stand-alone corporate trust company. In either case, the trustee will generally be an independent legal entity, separate from other parties to the transaction.

In a CMBS transaction with English law trust documents, as with other securitisations, two trusts are established under the documents. The same corporate trustee will usually act as trustee of both trusts, and the roles may be merged into one trustee position (although in the CMBS world this is not always the case). However it is important to note that in all cases, the trusts are very separate legal structures.

In a securitisation, the issuer will grant security over all of its assets to secure its obligations to its creditors (who will then be referred to as secured creditors). This security is granted to the security trustee, who is appointed to hold such security on behalf of all secured creditors of the issuer. The beneficiaries of the security trust will include the noteholders, as well as the other creditors of the issuer, such as the swap counterparty, liquidity provider, corporate service provider, third party agents and the trustee itself. This trust is referred to as the Security Trust.

The Security Trust will usually be effected through a deed of charge or security trust deed, under which the Security Trust will be established and the issuer will grant security. This document will also enunciate certain matters relating to the security trustee including powers, indemnities and liabilities, as well as the position regarding conflicts between beneficiaries. The document will also set out matters relating the acceleration of notes on a default and enforcement of security subject to the trust.

The security trustee generally will only have an active role in the event of a default at the note level, in which case, it may need to accelerate the debt due under the notes, enforce the security and liquidate the assets of the issuer (which in a CMBS transaction will be the rights of the issuer under the loan agreements underlying the structure). It should be stressed that enforcement of the security at the securitisation level is distinct from enforcement of security at the loan level. Enforcement at the loan level will be pursuant to the security arrangements at the level of the underlying loan—the security trustee is not able to enforce security over the underlying properties in a CMBS transaction, it can only enforce the security granted by the issuer. It should also be noted that an enforcement of security at either the loan level or the note level does not automatically result in an enforcement at the other level, although it may have effects (such as cessation of regular payments under the loan where the loan level security is enforced) which result in enforcement at the other level in the structure.

The second trust established at closing in a securitisation is the note trust. Under this trust, the issuer will grant to the note trustee to hold on behalf of all noteholders the covenant to pay. The only beneficiaries of the note trust will be the noteholders. The note trustee effectively acts as the conduit between the noteholders and the issuer and is the entity through which any decision making powers of the noteholders are effected.

The note trust will generally be established and the note trustee appointed pursuant to a trust deed, under which the powers, indemnities and liabilities of the trustee are enunciated. Where more than one class of notes are issued, the trust deed will also contain provisions relating to conflicts between classes and in whose interest the note trustee should act. As a general rule, the note trustee will be required to act in the interests of the most senior class of notes then outstanding.

The role of the note trustee is less limited than the role of the security trustee. The note trustee may be required to act throughout the life of the transaction, with regard to any amendments, modifications or waivers required by the issuer to the securitisation documents. The note trustee may be required to convene meetings of noteholders to discuss such issues, or it may (in conjunction with the security trustee) decide that the requested matter falls within the discretion of the note trustee. Where a default occurs at the securitisation level, the note trustee may also liaise with noteholders regarding potential acceleration and enforcement.

Throughout this Chapter, despite the separate nature of the trusts, we shall refer to the trustee in the singular, without specific reference to the different roles of a security trustee or note trustee. This is partially for ease, but also on the basis that the same entity will usually perform both roles and in the market it is not uncommon to refer to the two trustees in this manner.

## 13.3 The epoch of litigation

Some readers may be familiar with AP Herbert, who in addition to sitting as the independent Member of Parliament for the University of Oxford (in the days when certain universities had their own representative in Westminster), was famous for his satirical articles in Punch. These articles were written in the form of judgments of the court, and through satire highlighted aspects of the law which AP Herbert believed needed reform. Some of these satirical judgments became so famous (such as the case known as ''The Negotiable Cow'') that they developed a life of their own, with some people uncertain as to whether they were real or not, and some judges (fully aware of their providence) making reference to them in their own real judgments.

The interesting point is that whilst some of AP Herbert's cases are so absurd as to be impossible, others could possibly be matters which the courts could consider. It is suggested that at least one of AP Herbert's cases be read before any reader of this Chapter independently decides to look at the cases relating to CMBS transactions! It will set an interesting perspective for any reader. Whilst the cases discussed in this Chapter may not always be as amusing as those by AP Herbert, they certainly address a number of important issues and consider points which perhaps had often taken for granted. At least one judge has referred to a CMBS as a structure of Byzantine construct, perhaps a phrase which some of AP Herbert's judges may also have used had he penned a satire about them.

As noted in the last edition and above, the challenging circumstances that many of the remaining pre GFC CMBS transactions have faced, has meant that the roles of certain parties, including the trustee and the issuer, have continued to evolve in ways not anticipated when the transactions were structured and executed. In particular, as transactions near maturity, it is likely that the remaining underlying loans will be those with a more questionable credit quality, often with limited cash-flows available for distribution to investors. Frequently the loans underlying the CMBS will have defaulted and be subject to restructuring, enforcement or some other form of recovery maximisation. In these circumstances, the risk that creditors to the CMBS (being the noteholders and other secured creditors) may suffer a loss increases dramatically. As such, it is not surprising that at this time parties may consider their position closely and consider whether there are intercreditor questions (see Chapter 7) which may arise alter their entitlements or their ''position'' in the transaction.

As such, since 2012 issuers and trustees have regularly been involved in considering issues between various creditors in a CMBS transaction. As noted above, some of these issues may be settled in a consensual manner, through the parties coming to any agreement as to how to deal with the issue (through noteholder consent or agreement between parties) or finding a way to resolve the issue otherwise within the parameters of the transaction documents.

However, where consensual resolution is not available or possible, parties have increasingly seen the courts as an alternative means to settle the issue and provide a determination binding on all parties. Recourse to the courts is nothing new, and securitisations have periodically ended up in front of the courts. However, since 2014, the courts increasingly have been involved in considering issues facing trustees, issuers, servicers and other parties in interpreting the provisions of transaction documents across a range of structured products, including a number of CMBS transactions.

Unscientifically, this involvement of the courts can be generally divided into two areas with regards to CMBS transactions:

(i) questions of interpretation of contractual provisions; and
(ii) disputes between parties to the transaction which results in adverse litigation.

The use of the courts to resolve issues in interpretation, as well as the potential for litigation to be an asset to issuers in securitisations (as well as a liability of course—see Chapter 10 of the last edition of this book for a discussion of litigation as an asset) has had an impact on the role of the trustees and issuers in CMBS transactions. As central parties to the transactions, trustees and issuers have more regularly been involved in seeking the assistance of the court (or being parties to matters before the court) although the vast majority relates to questions of interpretation, which as discussed further below is less adversarial in nature than traditional disputes between parties.

### 13.3.1 Questions of interpretation—what did parties to the transaction mean?

> ''Unlike substantive law—for instance the law of tort, or the law of property—interpretation is ultimately intuitive. There are no rules.
>
> The reason why it is an art, not a science, is because we are ultimately trying to work out what the parties wanted to achieve from what they have said and done.''
>
> **Richard Calnan**[2]

> ''The set up and structure of the various transactions [Theatre Hospitals CMBS] seems to a simple minded property lawyer to be Byzantine in the extreme.''
>
> **Mr Justice Peter Smith, (the Theatre Hospitals Case) *Citicorp Trustee Company Ltd v Barclays Bank Plc***[3]

> ''A highbrow is the kind of person who looks at a sausage and thinks of Picasso.''
>
> **AP Herbert, An Uncommon Law, ''Is 'Highbrow' Libellous?''**

As CMBS practitioners will be aware, whilst the rationale and logic of a CMBS is not overly complicated, CMBS transactions, by their very nature, are highly structured deals with a number of layers. The underlying layer is the loan facility, which may, as discussed in Chapter 5, have been tranched through an intercreditor agreement under which certain aspects of the underlying facility may have been modified or amended (such as waterfalls). The senior loan may then have been securitised, and further amendments and modifications may have been made to the underlying structure (or the cash flows which derive from the senior loan). This complexity, when combined with the speed at which CMBS transactions were executed in the heydays of 2006 and 2007 meant that not every issue was addressed or dealt with in the tomes of documentation produced for each transaction.

One of the main issues arising in the documentation is the fact that CMBS transactions were often considered to be ''cookie cutter'' deals at the securitisation level; like RMBS transactions minimal amendments were required between ''repeat'' deals. However, this was not necessarily always appropriate. As a general rule, CMBS transactions are not homogenous structures with identical loans. Rather, due to the nature of the financing, there will most likely have been active negotiation of each underlying facility. This means that consideration needs to be given to the structure, both legal and economic, for each loan. For example, in a CMBS there may

2 Richard Calnan, *Principles of Contractual Interpretation* (Oxford: Oxford University Press, 2013).

3 [2013] EWHC 2608 (Ch).

be a selection of loans, some of which are partially amortising, others which are bullet repayments. There may be other deals which only have one or the other type of loan in them. These differences may have a significant impact on aspects of the securitisation.

When a transaction continues to perform, the documents are generally not subject to detailed analysis post-closing. However, as noted above, when a transaction is under stress, issues often arise which require detailed consideration of the position under the documentation. It is at these times that it becomes evident that either the documents do not entirely work together or do not address certain issues.

Documentation issues are arising most frequently when the transaction is nearing default and enforcement of the underlying loans have occurred or will occur. When drafted, detailed consideration and analysis was generally not given to the position of the transaction during default and enforcement of the underlying loans, nor as to how various components of the transaction would operate together. Issues arise, which are not specifically dealt with in the documentation. In such a situation, the servicing entity and/or the issuer and trustee (depending on what the specific issue relates to) are required to consider the parameters of their powers and any discretion which the documents may permit them. As a general statement, the parties to these deals have been proactive in addressing these issues and ensuring that a transaction is not caught in a stalemate. This has meant that the servicers, trustees and issuers have had to be engaged with a variety of highly complex issues and consider the ramifications of various positions and proposals.

For some of these issues, consideration can be given to the discretionary powers given to the trustee at the note level (or the servicer at the loan level, discussed further in Chapters 9, 10 and 11) to agree to amendments, waivers and modifications to the transaction documents. Under certain circumstances the trustee may be minded to exercise its discretion and agree to amendments etc., and as such, resolve issues relating to the documentation. However, it should be stressed that such action by a trustee is discretionary in nature (i.e. the trustee has no obligation to agree to exercise the powers granted to it) and will be subject to the trustee receiving comfort on various matters, including analysis of the documents, as well as possibly being indemnified, prefunded or secured to its satisfaction. In addition, it is standard in all Eurobond transactions for these powers to be limited, such that they cannot be exercised where such action would be (or could be considered to be) materially prejudicial to the interests of the noteholders or would have an effect so fundamental that it is deemed a modification of the basic terms.

Where the issue being considered may be prejudicial to the interests of the noteholders (which, when the question relates to intercreditor rights, tends to be the case), the trustee will generally be precluded from exercising its discretion. In these circumstances, noteholder consent by way of extraordinary resolution may be possible. However, where different classes of noteholders have different interpretations of the issue, it is likely that such a resolution is unavailable. It is in these circumstances that issues as to construction and interpretation of contracts may need the assistance of the court in order to be resolved. As discussed above, since 2014, trustees, issuers and other transaction parties have sought the assistance of the court in matters relating to the interpretation of provisions within the transaction documents.

#### *13.3.1.1 Part 8 Proceedings*

For English law questions of interpretation, there is a tried and tested route for seeking the court's determination on the interpretation and construction of the provision (or provisions) in question—a Part 8 proceeding. Part 8 proceedings are used for the determination of claims that do not have a substantial dispute of fact and are capable of being resolved without some of the procedural stages, such as lengthy pleadings, disclosure and oral evidence required in standard proceedings before the English courts. Part 8 claims are typically used when seeking a declaration on the construction, meaning or interpretation of the contract, and it is in this context that they have periodically been used by parties to CMBS transactions (as well as in other structured products such as CLOs and SIVs).

As noted above, seeking the involvement of the court is often not the first route taken by parties when considering an issue in the documents. Generally the parties will consider whether the issue can be resolved in an alternate manner. It should be stressed that both the trustee and the issuer have limited control over this process. Whilst they can assist the parties in considering the relevant provisions, ultimately a consensual agreement can only be reached if the parties with an economic interest in the transaction agree to such an approach within the terms of the documents. As discussed above, neither the issuer nor the trustee have such an economic interest in the transaction, and the trustee has a general obligation to act in the interests of all classes of noteholders, which would preclude it from agreeing to an approach which is prejudicial to some but not all classes of noteholders. As such, Part 8 proceedings are generally commenced after consideration and discussion of the issue between various parties to the documentation, and it becoming evident that either (i) the documents do not provide a solution to the issue or (ii) a consensual agreement as to how the provisions should be interpreted or construed cannot be reached.

Part 8 proceedings may be initiated by any party to the transaction documents, and there have been instances where Part 8 proceedings relating to CMBS transactions have been initiated by trustees and issuers, as well as other parties to the documentation, such as noteholders and liquidity facility providers. Even where the Part 8 proceedings are initiated by parties other than the trustee or issuer, the issuer and trustee will generally be involved in discussions relating to the parameters of the proceedings, prior to the proceedings being initiated. For example, in Part 8 proceedings it is common that the questions for the consideration of the court are agreed by the parties prior to the hearing. In some cases, the trustee or the issuer may take a lead in formulating the questions for the court. However, even when not actively involved in formulating questions for the court, the issuer and trustee will still be involved in discussions relating to the parameters of the questions for consideration.

One of the benefits of Part 8 proceedings is the ability to ensure that the decision of the court binds all the parties to the transaction. In order to achieve this, where a certain party (or class of party) is not joined to the initial proceedings, the court may join such party or a representative of such party to the proceedings. For example, where no noteholder is a party to the proceedings (or a particular class of noteholder which may have a view on the issue being considered by the court) the court may deem it necessary to join a representative of noteholders (or the relevant class of noteholders) to such proceedings. The mechanics may vary. In the Theatre Hospitals Case, Mr Justice Peter Smith first directed that the servicer be joined as a party and identify, on a confidential basis to the other parties' lawyers only, the identity of one junior noteholder. That junior noteholder was designated as ''Defendant XY'' in the proceedings and the Trustee was ordered to serve all of the documents in the action upon XY who was made a representative defendant so that all the junior noteholders would be bound by the judgment. By ensuring that all relevant parties are bound to the judgment, it means that a party who does not participate in the proceedings is not able, at a later stage, to dispute a judgment unfavourable to it.

In addition, whilst the parties in a Part 8 proceedings, due to the nature of the proceedings (i.e. parties arguing alternative interpretations of the documents) may take adverse positions to each other, the process would not normally involve cross-examination of witnesses of fact or expert witnesses and thus is rather less adversarial in nature than most claims before the courts. This is due to the fact that the parties are not disputing the facts but rather solely disputing the interpretation and construction of certain provisions. As such, Part 8 proceedings are often considered an efficient way to bring an issue before the court which allows parties to present arguments as to their own interpretation without necessarily being truly adversarial in character, and being constructed in such a way as to bind all parties to the transaction. The less adversarial nature of the proceedings means that the usual ''loser pays'' costs rule will not necessarily apply and the parties may bear their own costs subject to the ability of the trustee and issuer to rely on their right to indemnity or other contractual entitlement. However, even in Part 8 proceedings adverse costs orders are sometimes made.

A final point on Part 8 proceedings relates to the nature of the judgments. Part 8 proceedings are often referred to as being a useful way to address an issue in the documents which may arise across a number of transactions (and even across a number of conduit issuers). As such, Part 8 proceedings may be brought on one transaction, as a ''test case'', with the hope that the court will give a judgment that can equally be applied to other transactions without there being any risk that parties to the other transaction will challenge the application of the relevant determination of the court. Whilst in theory this sounds commendable, it is not always an easy thing to achieve. By their very nature, most transactions will be slightly different (even across the same conduit programme), with different investors and third parties, and different sets of underlying facts. Often judgments are given which, whilst containing certain statements which may have a more general application across transactions, do not necessarily address the main point, the ''test case'' point in such a generic manner (or address it by way of obiter dicta, which has been criticised by certain commentators). Rather the determination is tied to the specifics of the relevant transaction. This is hardly surprising given the role of the courts (and the precedential value of a judgment of a lower court), however, it can at times be frustrating for participants in the market. It is often asked why an issue in one transaction cannot be addressed in the same manner as another transaction where the issue was subject to Court direction. Unfortunately, owing to the nature of judgments (being fact specific and only binding the parties in that transaction), unless there is a clear and unambiguous declaration as to interpretation given by the court, where the issue has significant impacts upon the rights of different creditors, it will be quite difficult to adopt the same interpretation on another transaction.

#### *13.3.1.2 The Sompo principle*

As noted above, trustees will generally be a party to Part 8 proceedings relating to a CMBS transaction. Often Part 8 proceedings will be initiated by another party to the transaction. However there are times when owing to the nature of the issue or the facts relating to the transaction (such as the transaction having been accelerated or the issue relating to the exercise of a discretion by the trustee) that the trustee is the most appropriate party to start Part 8 proceedings. Even when the trustee initiates the Part 8 proceedings itself, it may take a neutral stance and not actively argue a position. In this situation it will give parties with an economic interest in the issue the opportunity to present their positions to the court, in order for the court to give directions as to how the provision or provisions should be interpreted.

However, the trustee will always make itself available to assist the court in reaching a determination on the issue being considered. There may be times when it is recognised that there is a dispute as to the interpretation of a provision, however, for various reasons, one party to the dispute is not represented in the court proceedings. This has been seen in cases where noteholders have been reticent about taking a role in the proceedings, even though the proceedings could prejudice their rights.

This was the situation in *State Street Bank and Trust Company v Sompo Japan Insurance Inc*[4] (the Sompo case), which involved an intercreditor dispute in a synthetic CLO. In the Sompo case, despite a noteholder being joined to the proceedings, no representative of the noteholders was represented before the court. The Chancellor noted that in these circumstances, the trustee, notwithstanding its neutrality in the dispute as between various classes of creditors, had an obligation ''to assist the court by bringing to the court's attention any relevant legal proposition or argument affecting the position of unrepresented beneficiaries or parties''. The Chancellor further noted that a trustee in this position has been likened to a watchdog for unrepresented interests.

We have seen the Sompo principle applied in Part 8 proceedings relating to CMBS transactions. As noted above, in the Theatre Hospitals case, a representative of noteholders was joined by an order of the court as ''Defendant XY''. In addition, the court asked the trustee to present arguments which would have been available to the junior noteholders (who were not represented in court, despite a representative being joined). Similarly in the DECO cases (as defined below), the trustee argued a positon in accordance with the Sompo principle. When acting in accordance with the principle, the trustee is presenting such arguments in order to assist the court, and does not impact its neutrality with regard to the issues being considered. Nor does it impose on the trustee an obligation to present every argument which the unrepresented party may have available to it. Rather the trustee is only required to draw to the courts attention possible arguments.

However, the application of this principle does explain why we sometimes see the trustee presenting arguments before the court which one would usually expect to see argued by a party with an economic interest in the transaction.

#### *13.3.1.3 Part 8 proceedings—tell us more*

> ''For practically every statement about how to interpret contracts, you will find a contradictory one. There is authority for just about every approach to interpretation''
>
> **Richard Calnan, Principles of Contractual Interpretation**

In order to highlight the variety of issues considered by the courts in Part 8 proceedings, it is worthwhile considering a number of recent cases. Four sets of cases will be considered below, the first two involve similar questions of construction which have arisen across more than one transaction (and more than one conduit issuer) whilst the second two may have more limited application, although are still quite interesting for CMBS practitioners.

4 [2010] EWHC 1461 (Ch).

It should be noted that in most of the cases a number of issues were considered by the court. The case studies have however been limited to certain questions before the court and as such, do not address all the points raised in the various judgments.

13.3.1.3.1 Special servicer transfer cases

One issue which has vexed European CMBS deals is the issue of transferring the role of special servicer. In the US, transfers of special servicers are regular events in CMBS transactions, regularly tied to the change in ownership of the B piece in a CMBS transaction.

As discussed in Chapters 9 and 11, in Europe, the possibility of transfers also exists in CMBS transactions. It is not uncommon for the controlling party to be given a similar right to terminate the appointment of the special servicer without cause (and have the right to appoint the new special servicer). However, such terminations have been very limited in the European market. This is due to a number of reasons, including the requirement to satisfy certain pre-conditions before a new special servicer is appointed. One of these conditions is the receipt of rating confirmation from the rating agencies that such transfer will not result in the downgrade of the notes. Yet, a problem has arisen in Europe due to the policy of Fitch not to provide such confirmations.

The trustees in two transactions sought the determination of the court on the rating agency confirmation point (in addition to certain other points relating to the issue of termination and appointment of a new special servicer, to which we refer the reader to the relevant cases). These cases are *US Bank Trustees Limited v Titan Europe 2007-1 (NHP) Ltd*[5] (the Titan 2007-1 case) which related to the Titan Europe 2007-1 CMBS transaction and *Deutsche Trustee Company Ltd v Cheyne Capital (Management) UK (LLP)*[6] (the DECO cases) which related to the Deco 15–Pan Europe 6 Limited CMBS transaction. In addition, as noted above, in the DECO cases, in accordance with the Sompo principles, the trustee advanced an alternative interpretation to that advanced by the representative of the controlling class.

In each case the court was asked to construe the rating agency confirmation requirement for the replacement of a special servicer in light of the fact that Fitch would not issue rating agency confirmations.

In the Titan 2007-1 case, the court's determination on this point focused closely on a provision in the documentation which at its time was quite unusual. The servicing agreement for the Titan 2007-1 transaction included a provision which stated that if a rating agency declined to issue a rating agency confirmation, then a provision requiring such confirmation would

5 [2014] EWHC 1189 (Ch).
6 [2015] EWHC 2282 (Ch).

be construed as though such confirmation was not required. It should be noted that such a provision is standard in CMBS 2.0 transactions in Europe. The court ruled that, on the basis of this provision, it was clear that the commercial agreement was that the failure of a rating agency to provide a rating agency confirmation should not in and of itself stop the transfer from taking place.

The decision of the High Court in the DECO case was somewhat different. Commentators have argued (and this was also recognised by the High Court) that the difference between the approaches of the court in the Titan 2007-1 case and the DECO case was due to the fact that the transaction documents Deco 15–Pan Europe 6 Limited CMBS transaction did not include the wording contained in the Titan Europe 2007-1 CMBS transaction. In addition, the documents in the Deco 15–Pan Europe 6 Limited CMBS transaction included the ability for noteholders by way of extraordinary resolution to ''override'' the rating agency confirmation condition (which, owing to the way the extraordinary resolutions were structured, effectively meant only the most senior class of noteholders needed to approve the transfer if the conditions were not all satisfied). The High Court held that on this basis, there was no ability to transfer the special servicing role without a rating agency confirmation from Fitch unless an extraordinary resolution of noteholders approved such transfer. In May 2016, the Court of Appeal refused an application for permission to appeal against the first instance decision in the DECO case.

Conceptually, this would seem to indicate that, solely on the point of the rating agency confirmation condition, where the documents in a CMBS transaction are drafted along the lines of the documents in the Deco 15–Pan Europe 6 Limited CMBS transaction, it may be that a servicer transfer can only occur with the consent of noteholders acting by way of extraordinary resolution. However, where they include the language from the Titan 2007-1 CMBS transaction, or language with greater flexibility on this point, such transfers may be possible notwithstanding Fitch's policy on rating agency confirmations.

13.3.1.3.2 Class X interest cases

Another issue which has arisen across a number of transactions relates to the calculation of the rate of interest on class X notes. This issue (amongst others) was considered by the court in two sets of Part 8 proceedings, one relating to one of Lehman Brothers' Windermere CMBS transactions (the *Hayfin Opal Luxco 3 S.A.R.L. v Windermere VII CMBS Plc*[7] (the Windermere case)) and the second relating to four deals from Credit Suisse's Titan CMBS transactions (*Credit Suisse Asset Management LLC v Titan Europe 2006-1 Plc*[8] (the Titan cases)). It should be noted that the decisions in both cases are

[7] [2016] EWHC 782 (Ch).
[8] [2016] EWHC 969 (Ch).

subject to part appeal, and that these appeals are due to be heard in the latter half of 2016.

Both cases related to the calculation of the rate of interest on class X notes, discussed in detail in the last edition to this book. The issue before the court related to whether or not the calculation of class X interest should take into account amounts which accrue on an underlying loan following its default (often referred to as ''default interest'') or whether such amounts were excluded from the calculation of class X interest. In addition, the court was asked to, amongst other issues, consider what rate of interest would apply to any unpaid amounts on the class X notes (as, owing to the nature of the payments under the class X notes, the actual rate of interest on the class X principal amount could be significant multiples of the principal (e.g. in the Windermere CMBS up to 6,001% per quarter), which certain parties contended was essentially a penalty, and as such, unenforceable).

In both judgments the court found that ''default interest'' on an underlying loan should not be taken into account when calculating the rate of interest on the class X notes. As both cases found that class X interest had correctly been calculated, there was no unpaid class X interest, and as such, the question of what rate of interest applied on unpaid amounts did not need to be addressed. In the Titan cases, the Chancellor specifically noted this. However, in the Windermere case, Mr Justice Snowden gave an obiter view on this issue and noted that if one used the true rate of interest on the class X notes, the rate on unpaid amounts would be exorbitant (if not extortionate) and as such fell foul of the penalty doctrine. Such statement does however rather raise another interesting question; if class X interest amounts ever were unpaid, at what rate would interest accrue on such unpaid amounts?

In any event, as noted above, both the Windermere case and the Titan cases are subject to appeal, and as such, the position may change (or be further clarified).

An interesting point about both cases is that the second edition of this book was included in oral arguments by various parties. Further, in the Windermere case, Mr Justice Snowden in his judgment quoted the last edition of this book when explaining some of the issues which have arisen with regard to class X notes, an indication of the market-leading nature of this book.

#### 13.3.1.3.3 Theatre Hospitals case

The Theatre Hospitals case has been mentioned above, however, it is probably worth giving some more detail on this Part 8 proceeding.

The Theatre Hospitals cases related to the term ''outstanding'' and how to interpret the provisions disenfranchising certain classes of noteholders. It is not unusual in Eurobond transactions for noteholders related to the issuer or originator to be disenfranchised from certain matters including meetings of noteholders, the power to instruct, calculation of amounts of notes outstanding or certain determinations by the trustee. The issue arose when the underlying loans were nearing default and needed to be restructured, yet it was unclear who could provide the appropriate instructions to the trustee and others. The definition of ''outstanding'' disenfranchised each seller (across the two deals, there were four sellers of loans), yet one of the sellers of the loans (to whom we shall refer as ''B'') held notes, both directly as noteholder (the B Notes) and potentially also had an interest in certain notes which B had transferred to R under a financing arrangement, but which B continued to contractually control certain matters such as voting on amendments (the R Notes).

The court had to determine whether (i) the B Notes were disenfranchised on the basis that ''seller'' in the disenfranchisement clause identified B in whatever capacity; (ii) the R Notes were disenfranchised on the basis that they were beneficially held on behalf of a seller, B, since although B had no proprietary interest in the notes, it had an interest in them in an economic sense.

In addition to describing CMBS structures as Byzantine, Mr Justice Peter Smith held that (i) the purpose of the provisions was to prevent B, in its capacity as seller, from exercising its votes attached to its notes in its own interest. The preferred approach would be that the word ''seller'' was intended to have the effect that, when it was holding the notes as a seller, the holder was disenfranchised. B was no longer holding any notes in its capacity as a seller, therefore it was not disenfranchised. Further, Mr Justice Smith also held that (ii) B held the B Notes legally and beneficially, and R held the R Notes legally and beneficially. There was no suggestion that B had acquired any interest in the R Notes; this was separate from the fact that B contractually controlled the voting of the R Notes due to other arrangements. Neither the R Notes nor the B Notes were disenfranchised.

#### 13.3.1.3.4 Gemini liquidity facility case

The final case which is deserving of mention as it relates to Part 8 proceedings, was brought by a liquidity facility provider. It is also considered a very strong statement that the court in such interpretation matters would adopt an interpretation of a disputed term that is most consistent with business common sense.

In *Gemini (Eclipse 2006-3) Plc v Danske Bank A/S*,[9] ''D'' provided the liquidity facility (the LF) to the CMBS. Owing to downgrades, the LF was fully drawn as a standby facility. Following to the introduction of Basel II in Denmark, D was entitled to charge for ''increased costs'' (and it should be

[9] [2012] EWHC 3103 (Comm).

noted that this entitlement was not disputed) under the LF, however the LF also included a threshold for payments due under it, pursuant to which amounts payable over a certain threshold were treated as liquidity subordinated amounts (LSA). As such, the vast majority of the ''increased costs'' exceeded the threshold, and as such, could only be paid as LSA (which ranked junior to amounts due on to noteholders).

The LF permitted expenses drawings, which could be used by the issuer to meet amounts due to certain secured creditors. Importantly the LF prohibited expenses drawings being used to pay amounts due to noteholders.

The court was asked to consider whether an expenses drawing could be used to pay the LSA (and related to this issue, when the LSA would become due and payable). In his judgment, Mr Justice Cooke agreed with the arguments put forward by the issuer, essentially confirming that an expenses drawing could only be made when an amount was due and payable by the issuer and that the LSA was not due and payable until such time as all senior amounts had been paid. Mr Justice Cooke also reaffirmed that this interpretation was most consistent with business common sense.

13.3.1.3.5 The Financial List

The complex and market specific issues which arise in the type of Part 8 cases described above are such that there may be benefit in those cases being heard by a specialist judge. The Financial List became operational in the Chancery Division and Commercial Court on 1 October 2015. The Financial List helps ensure that cases which would benefit from being managed and heard by a judge with particular expertise and experience in the law relating to the financial markets, or which raise issues of general importance to the financial markets, are dealt with by judges with suitable expertise and experience. For inclusion in the Financial List a claim should: (i) relate to banking or financial matters and be for more than £50 million; or (ii) require particular expertise in the financial markets or (iii) raise issues of general importance to the financial markets.

The Windermere case was heard in the Financial List and the Titan cases were heard by the Chancellor of the High Court, a Financial List Judge, and transferred to the Financial List prior to appeal. It remains to be seen whether the further development of specialist knowledge on the part of the nominated judges of the Financial List makes Part 8 proceedings a more attractive route for transaction parties.

### *13.3.2 Litigation to add value or defend value in the CMBS*

Part 8 proceedings are not the only type of litigation involving CMBS transactions. In recent years, litigation has been brought by various parties to these transactions which does not relate to questions of interpretation.

Rather this litigation is seeking damages against one or more parties to the transaction, broken down into two sets of examples:

(i) valuer negligence litigation;
(ii) borrower litigation.

*13.3.2.1 Valuer negligence litigation*

In the last edition of this book, a section entitled ''*litigation can be an asset*'' was included in the discussion of the evolving role of trustees and issuers in CMBS transactions. It considered rights attaching to the underlying loans which are transferred by the originator as part of the sale process (both contractual rights and security rights—these together are often referred to as ''Ancillary Rights'' or ''Related Collateral'' ) as well as the contractual rights which the issuer has directly against third parties to the transaction. The section also noted that whilst a transaction continues to perform, the assets of the issuer other than those relating to the underlying receivable originating assets and security are less likely to be actively considered (or to have any real value). However, once a transaction is in trouble and the ''traditional assets'' of the structure no longer have sufficient value to cover the debt owed to the noteholders, the issuer (or its agents, in particular the servicing entity) may need to consider whether there are any other assets of the structure which could increase the receipts available to the issuer to satisfy its debts as and when they fall due.

This may involve considering whether the issuer has any contractual or other claim against any third party (either directly through contractual relationships between the issuer and a third party, or as part of the assigned ''Ancillary Rights'' or ''Related Collateral''). These may include considering whether any representations were incorrect at the time they were given (such as representations given as to the assets on the date of transfer) or whether any specialist adviser (such as a lawyer, valuer or auditor) gave advice which was negligent. In the former case, the third party may have an obligation to remedy such breach (with regards to assets, generally by repurchasing the assets in question) and in the latter, the issuer may have a claim either in contract or tort.

At the time of the writing of the last edition of this book, valuation claims were still being considered in the abstract, as there had not been any litigation relating to such matters. In the intervening years, whilst there has been considerable discussion in the CRE market regarding negligence claims against valuers, there has been limited litigation regarding this issue. This may be due to a number of the issues raised in our section on ''*litigation can be an asset*'' or to various other developments in the market.

However, it is worth considering the main case on this topic as part of this Chapter's analysis of litigation in CMBS transactions.

13.3.2.1.1 Titan Europe 2006-3 v Colliers

This discussion is actually an analysis of the High Court decision (*Titan Europe 2006-3 Plc v Colliers International UK Plc (in liquidation)*)[10] and the related decision of the Court of Appeal (*Titan Europe 2006-3 Plc v Colliers International UK Plc (in liquidation)*.[11]

The issuer (''T'') brought a professional negligence claim against the defendant valuation company (''C'') in respect of its valuation of a commercial property in Germany which had been built for the in situ tenant. When the owner of the property sought a loan, C valued the property at €135 million for the bank, partly based on the assumption that the existing tenant would continue to occupy the property and pay a significant rent. The loan was later securitised in the Titan Europe 2006-3 CMBS. The tenant later became insolvent, with its administrator quitting the lease which in turn caused the borrower to default on the loan and became insolvent. As a result the property was to be sold for only €22.5 million.

Owing to this decrease in value, T sued C for negligence. The key issues before the High Court were (i) whether T or only the noteholders could claim against C, and (ii) whether C's valuation had been negligent.

The High Court found in favour of T. It held that (i) rights arising from a debt instrument such as T's notes attached to the notes for the benefit of the holder for the time being, but the securitisation had not been structured so that the noteholders were the parties with the right to sue in respect of allegedly negligent valuations. Economically, the investors in the notes had suffered the loss. However, it did not follow that T had not suffered loss in respect of which it could claim. T was able to show that it was contractually obliged to distribute any sums received in the action to noteholders. On the premise that T could show reliance and causation, it had suffered a loss the moment it purchased the loan because it had acquired a chose in action worth less than the price paid. More generally, the courts were reluctant to accept ''no loss'' arguments in cases involving complex structured financial transactions as the distribution of loss could be difficult to pin down. The important points were that where the contractual structure allocated the bringing of a type of claim to a particular party, that party brought the claim, complying with any conditions for doing so, and that the proceeds were dealt with according to the contractual requirements. Applying those principles, T was entitled to bring the claim. It also held that (ii) C's valuation had been negligent. A reasonably competent valuation would have considered the fact that there was a real risk that the tenant could leave and the problems that the empty building could pose. C had failed to give sufficient weight to the fact that the property was likely to attract poor

[10] [2014] EWHC 3106 (Comm).
[11] [2015] EWCA Civ 1083.

demand because it was large, old and built to the needs of the tenant's particular business.

C appealed both decisions to the Court of Appeal, which allowed the appeal. With regard to the negligence claim, the first instance judge's finding as to the proper valuation of the property was too low; the valuation that the Court of Appeal found to be correct just fell within the 15% bracket for margin of error from C's valuation. Regarding the issue as to whether T could claim against C, as C was found not to have been negligent, the Court of Appeal did not make a finding on this issue. However Lord Justice Longmore believed that this issue was an important issue for the securitisation industry, and felt it was important for the Court of Appeal to express a view on it. In an *obiter* statement he noted that had the Court of Appeal upheld the decision of the High Court regarding the negligence of C, the Court of Appeal would have also upheld the decision of the High Court to the effect that T could sue C. The issuer's relationship with the noteholders was found to be analogous to that of a company with its shareholders.

As such, the Court of Appeal's decision gave some clarity to whether an issuer could suffer a loss and sue for such loss. However, both the High Court decision and the Court of Appeal decision also highlighted the difficulties in proving professional negligence, in particular in a case where the factual pattern was complicated.

*13.3.2.2 Borrower litigation*

The final type of litigation we have seen over the last few years is litigation at the loan level. As this Chapter is considering issues at the CMBS level, it may not directly fit within the parameters of discussion. However, it is deserving of discussion in this Chapter.

Since 2013, as loans go into default and are enforced, some borrowers and other creditors at the loan level have used litigation as a tool to protect their position. Owing to the nature of the claims, often the issuer and trustee are not directly involved, as the servicer or special servicer will be taking the lead on this litigation on behalf of the issuer. Market comments indicate that the claims can relate to a variety of points ranging from the origination of the loan to enforcement strategies being implemented to liquidate the defaulted loan. However, such litigation may involve the issuer, as the lender of record. As such, it is undoubtedly part of the evolving world of trustees and issuers in CMBS transactions.

## 13.4 Conclusion

This Chapter has considered the rise of litigation in CMBS transactions and in particular the increased use of the courts to determine questions of interpretation and construction. This increase is not surprising given where the market are in the life-cycle of CMBS transactions. As transaction cash-flows become stressed, parties may consider their position closely and consider whether there are intercreditor questions which may arise and which may alter their entitlements or their ''position'' in the transaction. As such parties raise conflicting interpretations of provisions and documents, and owing to the nature of the issues and its impact on various creditors, transaction parties have been increasingly seeking the courts' determination in these disputes. Of course, some might argue that these issues may have been avoided with drafting hindsight, but as always, hindsight can be a dangerous tool.

Part of the attraction in seeking the determination of the courts on matters of interpretation has been an understanding that the courts are likely to construe the documentation in a commercially sensible manner. This has not always been the case, but rather derives from a large number of cases dealing with interpretation of contracts over the last 20 years, and in particular the principles on interpretation set out by Lord Hoffmann in *Investors Compensation Scheme Ltd v West Bromwich Building Society*.[12] In this case Lord Hoffmann enunciated five principles of contractual interpretation, principles which have been generally applied by courts in subsequent cases, including cases relating to structured finance and structured products. This has given parties comfort that the court will try and achieve an interpretation which is commercially sensible where alternate views are possible.

A number of cases relating to structured finance transactions have quoted the Supreme Court's decision in *Rainy Sky v Kookmin Bank*,[13] which stated that where the language of the parties could be construed in two different ways, the aim was to adopt ''the construction which was most consistent with business common sense, by an iterative process involving the checking of each of the rival meanings with the other provisions of the document and investigating the consequences. The aim is to ascertain what the reasonable person would have understood the parties to have meant by the words that they used, with such reasonable person having all the background knowledge which would reasonably have been available to the parties in the situation in which they were at the time of the contract''. The courts have generally tried to adhere to this approach when considering Part 8 proceedings relating to CMBS transactions.

Of course this is not an easy task for any person, and when one adds to the equation the complexity (or Byzantine nature) of a CMBS transaction, one tends to sympathise with the judges who need to consider the issues raised in CMBS litigation.

12 [1997] UKHL 28.
13 [2011] UKSC 50.

Whilst it is not certain when the next Part 8 proceeding relating to a CMBS transaction will find its way in front of a court, it is highly likely that the courts will continue to see such cases being brought before them, and will continue to analyse complicated questions as to interpretation of provisions which necessitate analysing and addressing a number of questions. As such, it is highly likely that trustees and issuers will continue to be involved in court proceedings, and continue to see their role in these transactions evolve.

In addition, issuers and possibly trustees may be brought into litigation at the loan level. For the reasons discussed above, this could be viewed as a rather worrying situation. The assumption on closing of the transaction was that risks to the investors were largely known, or at least disclosed. However, if the issuer becomes involved in claims by a borrower, it could expose the issuer to potential liability and as such, potentially impact the possible already limited cash-flows available to noteholders.

Finally, it will be interesting to see whether further professional negligence claims are brought against valuers in CMBS transactions. Whilst the Court of Appeal decision in the Titan 2007-1 case overturned the High Court's finding of negligence, the obiter statements did indicate that an issuer could bring a claim against a valuer. Of course there are a large number of hurdles to any such claim, including the issue of limitation periods, as well as the fact that valuations are often highly complicated (as seen in the Titan 2007-1 case where various professionals gave widely varying valuations to the assets) and the usual application of the ''loser pays'' costs rule in the English courts. It is also noted that the professional negligence claim against Colliers by White Tower 2006-3 Plc (an issuer in a CMBS transaction) was withdrawn prior to judgment—perhaps an indication of the difficulties faced by issuers in these types of claims or of the appropriateness of settling?

In any event, the increase in litigation in CMBS transactions has had an impact on the role of trustees and issuers in these transactions. Courts have become more familiar with structured finance transactions and the intricacies of these deals, which in turn has potentially made court determination of construction issues more attractive and efficient to parties involved.

And to conclude with the involvement of the great AP Herbert in this Chapter, a final quote:

> ''Justice should be cheap but judges expensive.''