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Market Awaits English Court Rulings on CMBS Claims

April is set to be a busy month in the English courts for the CMBS community, as five cases come to trial in the High Court in London.

Four of those cases are the so-called "Class X" claims, which have been consolidated together and are due to be heard between 7 and 15 April. All four claims relate to 2006 and 2007-vintage Titan Europe and Cornerstone Titan CMBS. In each claim Credit Suisse Asset Management is the Class X noteholder, and will be asking the court to make declarations on how interest and principal under its notes should have been calculated.

Appreciating Class X

Class X notes in pre-2011 "CMBS 1.0" structures became a lightning rod for investors' ire following the collapse of the commercial real estate market during the financial crisis. Originally Class X was intended as a means of returning the "excess spread" (i.e. any surplus in the cash flows received on the underlying loans above the liabilities of the issuer) to the originator. The Class X notes were low face value, cash collateralized, disenfranchised from noteholder voting, and paid a variable interest rate pari passu with the Class A notes. But the difficulty is in determining what the excess spread is. Issues have arisen because documents define the excess spread in terms of the interest due on the underlying loans, rather than the interest actually received. In a non-performing deal that could entail the liquidity facility being drawn to pay a theoretical excess spread that doesn't exist in the real world. On some deals non-accruing interest mechanisms, which cause write-downs on higher yielding junior notes when losses on underlying loans are crystallised, further increase the excess spread payable to the Class X notes, even as the junior noteholders lose principal. And because Class X interest ranks pari passu with the most senior notes, it will always be paid before principal on any other class.

As Class X notes form a very small amount of the debt of the issuer, the Class X interest rate can be geared up to enormous levels. On a €700 million CMBS a one per cent excess spread would mean a €50,000 Class X note yields 14,000 per cent. That's fine so long as that really is the excess spread. But in the case of Titan Europe 2006-1, the €50,000 Class X noteholder was reported to be receiving over €200,000 on each IPD, while the €112 million Class B noteholders were receiving €36,000 and the remaining €177 million of Class C to H noteholders received nothing. In other words, originators of CMBS 1.0 deals are still getting huge windfalls as other note classes default.

Clash of the Titans

The cases coming to court are a variation on this theme. The issues are: (i) whether the Class X interest rate should take account of any additional default interest payable under the underlying loans; and if so (ii) whether the unpaid Class X interest should itself accrue interest at the Class X interest rate. In addition, since note events of default have occurred at the maturity date on the earlier maturing deals, the court is being asked to resolve the additional question of whether the Class X notes should be immediately redeemed with funds in the Class X accounts, or whether they should remain outstanding until all other notes have been redeemed. Again, while these can at first sight sound like trivial issues, because of the gearing of the Class X notes the sums at stake are significant. Analysts estimate that for Titan Europe 2006-1 Plc and Titan Europe 2006-2 Plc the interest calculation issues are worth €33.7 million and €19.5 million respectively. If the claims succeed this will be particularly problematic: payments have historically been made on the basis that default interest should not be included in the excess spread calculation.

Many of the structural flaws that have given rise to these and other issues with CMBS 1.0 have been resolved in more recent CMBS 2.0 deals. For example, in one 2014 deal the documents make clear that the liquidity facility cannot be drawn to make good a shortfall in amounts received under the underlying loans, and in circumstances such as a transfer to special servicing the right to excess spread becomes subordinated to payment of all interest and principal on the other classes of notes. But there remain a good number of pre-2011 deals yet to mature that still contain these latent issues. Many originators and noteholders will be watching to see how these cases turn out before taking a stance on their own notes. The court's judgment is awaited with interest.

About the Authors

Chris Webber is a partner specialising in structured finance disputes at Squire Patton Boggs. Mark Thomas is a partner specialising in structured finance. Jeremy Ladyman is a senior associate specialising in derivatives and structured finance.

To obtain a copy of a detailed analysis of the relevant provisions of the Titan Europe 2006-2 Plc notes please contact Chris at chris.webber@squirepb.com or on +44 20 7655 1655.

Contact

Chris Webber
Partner
T +44 207 655 1655
E chris.webber@squirepb.com

Mark Thomas
Partner
T +44 207 655 1048
E mark.thomas@squirepb.com

Jeremy Ladyman
Senior Associate
T +44 113 284 7250
E jeremy.ladyman@squirepb.com