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The Canary Wharf "Spens" Case: Why Welsh Caravan Parks Are a Danger to the Financial Markets

The Oxwich Leisure Park on Wales's Gower Peninsular might seem a world away from the concerns of Noteholders of a Canary Wharf securitisation following the sale of a £795 million skyscraper. But a decision in the Commercial Court last week (28 January 2016) showed how in the one-size-fits-all world of English contract law they can become intertwined, with unpredictable consequences for financial markets.

The Canary Wharf Sale

In *Canary Wharf Finance II PLC ("CWF2") v Deutsche Trustee Company Limited and others* a dispute arose between the Issuer of the A1 Notes and a representative group of Noteholders. The Notes were part of a CMBS that the Canary Wharf group of companies had used to finance a number of properties, including 10 Upper Bank Street (the "Property"). In simplified summary, CWF2 had issued Notes (including the A1 Notes) subject to contractual note conditions (the "Conditions"). It had on-lent the proceeds to CW Lending II Limited (the "Borrower") under an intercompany loan agreement (the "ICLA"). The Borrower had on-lent to a number of "propcos" including one that owned the Property.

The Canary Wharf group decided to sell the Property in June 2014. When the sale happened that triggered an obligation on the Borrower to make a prepayment under the ICLA to the Issuer sufficient to enable the Issuer in turn to redeem a portion of the A1 Notes. The question was whether that prepayment should be characterized as "mandatory" or optional. If it was mandatory the Issuer had only to pay the Noteholders the principal amount of the redeemed A1 Notes, £577.9 million. If it was optional, the Issuer had to pay a larger sum, calculated on a hypothetical scenario where the A1 Notes had appreciated in value until their yield matched treasury stock. This would mean the Noteholders would receive an extra £168.7 million on top of the par value of the Notes, a so-called "Spens payment".

The Reasons for Spens

The thinking behind this uplift is obvious. Canary Wharf group secured favourable (at the time) fixed borrowing rates by committing assets into the CMBS as security until 2033. Equally the A1 Noteholders gave up the flexibility of lending at floating rates or for shorter periods. The Noteholders were pensions and investment funds seeking consistent long term rates of return for their investors.

It would cut across those priorities if the Canary Wharf group could choose at any point to prepay the A1 Notes at par to refinance at cheaper rates. Noteholders would lose the long-term certainty they had bought. The large premium to redeem the Notes early compensates Noteholders for the loss of their fixed income cashflows by enabling them to use the premium to make the same returns from treasury stocks.

The English Courts' Approach

There was a time when this commercial sense would have been key. As Lord Clarke put it in the Supreme Court in *Rainy Sky SA v Kookmin Bank*, where a contract has *"…two possible constructions, the court is entitled to prefer the construction which is consistent with business common sense"*. As is often the case with complex finance agreements, there were two readings of the ICLA and the Conditions. The Issuer had a credible argument that the prepayment arose "from or as a result of the release of a Mortgaged Property", making it mandatory within Condition 5(b)(iv) of the Notes. The Noteholders argued convincingly that there was nothing *"mandatory"* about it: the Canary Wharf group had chosen to sell the Property. When *Rainy Sky* applied, the commercial context could make sense of these competing plausible interpretations when the numerous interrelated clauses did not provide a clear answer.

But in 2015 Oxwich residents took their fight over a rent escalation provision in their tenancies to the Supreme Court in *Arnold v Britton*, which changed the English courts' approach. As Lord Neuberger put it in his leading judgment, commercial common sense should no longer "be invoked to undervalue the importance of the language of the provision which is to be construed"; "save perhaps in a very unusual case…meaning is most obviously to be gleaned from the language of the provision".

So the first consideration is no longer the commercial rationale of the agreements. Semantic nuances of the clauses now hold sway. It is one thing to assume the draftsman of a simple tenancy agreement perfectly captured the parties' intentions in every conceivable scenario. Can that assumption apply to a suite of CMBS agreements?

All's Well That Ends Well?

Mr Justice Phillips managed to decide in the Noteholders' favour despite applying the *Arnold v Britton* approach and conducting a close analysis of the language of the agreements. He awarded the A1 Noteholders a £168.7 million Spens payment. He wisely went on to "cross-check" his conclusion by discussing the arguments on commercial context, and concluding that "it would make a nonsense of [the CMBS structure] and would undermine the value and benefit of the long-dated Notes…if the Issuer could redeem them at par at any time".

Mr Justice Phillips has extensive experience in financial markets cases, and was named in October 2015 as one of the inaugural panel to hear cases on the new "Financial List" set up to hear financial markets disputes. Although he described his review of the commercial arguments as a cross-check "for the sake of completeness", his approach to the contractual provisions would surely have been informed by his grasp of the rationale for a Spens payment. If not then the result could have been a lottery, with the court grasping to understand provisions that might have appeared to give the Noteholders an unearned windfall from the Property.

When the Canary Wharf group first announced that it would seek a court ruling on whether it had to make a Spens payment the price of the Notes dropped almost 10%, such was the market's lack of confidence that the court would reach the right result. Financial market participants should continue to be concerned that less experienced judges will make mistakes when complex finance agreements are read in a void divorced from the commercial incentives that formed them.

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