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Titan Europe 2007-1 (NHP) v U.S. Bank – An analysis of the High Court Ruling

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On 16 April 2014, Mr. Richard Snowden QC sitting as a Deputy Judge delivered his judgement (the "**Judgement**") on the directions sought by U.S. Bank Trustees Limited (the "**Note Trustee**") with respect to the Titan Europe 2007-1 (NHP) CMBS transaction (the "**NHP CMBS**").[1] Those directions related to the interpretation of certain contractual provisions of the Servicing Agreement dealing with the special servicer's replacement for the NHP CMBS.

The Judgement is the first English law decision to deal with the interpretation of contractual provisions relating to the termination of a special servicer without cause in the context of European CMBS transactions. This decision will most likely define the parameters going forward for termination of appointment of the special servicer and other securitisation parties.[2]

Transaction Structure

Titan Europe 2007-1 (NHP) Limited (the "**Issuer**") is a commercial mortgage securitisation vehicle whose notes (the "**Notes**") were issued on 24 May 2007. The Notes are commercial mortgage backed securities that represent the securitisation of the senior tranche (the "**Libra Loan**") of a loan (the "**Libra Whole Loan**") secured by senior care facilities located throughout the United Kingdom. At the time of issuance of the Notes, the largest tenant for the properties was Southern Cross Healthcare Group PLC ("**Southern Cross**").

In connection with the issuance of the Notes, the Issuer entered into a servicing agreement (the "**Servicing Agreement**") which provided for a servicer and a special servicer to act on behalf of the Issuer and the other finance parties as to the administration of the Libra Whole Loan. As in other CMBS transactions, the Servicing Agreement contained provisions for the transfer of servicing responsibilities for the Libra Whole Loan from the servicer to the special servicer (the "**Special Servicer**") upon the occurrence of certain specified events.

At the time of securitisation, the Libra Whole Loan was tranched into multiple tranches, consisting of the Libra Loan, which was securitised, and multiple subordinate tranches of different ranking (the subordinate tranches, collectively, are defined as the "**Subordinated B Loan**") pursuant to the terms of an intercreditor agreement (the "**Intercreditor Agreement**"), as was customary for large loan CMBS transactions. The Servicing Agreement and the Intercreditor Agreement provided for a representative for each tranche of debt. In addition, they provided for the identification of the controlling holder of the debt, which was to be determined based upon the valuation of the properties. As each tranche of the Subordinated B Loan moved further "underwater" based on the declining value of the properties, the representative of the next senior tranche would be the "**Controlling Party**". The valuation of the properties declined to such a significant degree that eventually none of the representatives of the Subordinated B Loans were the Controlling Party and, instead, the securitised Libra Loan was the controlling debt.

The Servicing Agreement provided for certain rights of the Controlling Party, including the rights to receive information, be consulted by the servicers and to give its approval in relation to certain matters in relation to the servicing and special servicing of the Libra Whole Loan. In addition, the Controlling Party was given the right to issue a notice of termination without cause in relation to the appointment of the Special Servicer.

Another feature of the NHP CMBS, which was unusual for a European CMBS, but not unique, was that it provided for a liquidity platform for the CMBS by means of "advancing" rather than the standard liquidity facility format. This structure involved an Advance Provider and a Backup Advance Provider. The Advance Provider was the entity that was obliged to provide a line of credit that was available for drawdown, subject to certain conditions being met, to provide funds to the Issuer to meet its payment obligations on the Notes as well as other circumstances. In the event that the Advance Provider failed to provide such advance, the Backup Advance Provider was obligated to make such advance. One of the primary conditions for when an advance could be made was that such advance must be "recoverable" from amounts the Issuer was entitled to receive with regard to the Libra Loan. The Advance Provider and the Backup Advance Provider relied solely on the Special Servicer's determination as to the recoverability of an advance.

Background

The Libra Whole Loan matured in January 2009 without any immediate prospects for repayment. The borrower and Capita Asset Services (UK) Limited (the "**Special Servicer**") attempted to consider and negotiate various proposals for a restructuring and during such period, the borrower negotiated a standstill. Unfortunately, the Special Servicer and the various creditors could not come to an agreement on the restructuring of the debt.

In June 2011, following the deterioration in its trading between 2009 and 2011, Southern Cross announced a restructuring to transfer its operations to other operators. During the summer of 2011, the directors of the obligors under the Libra Whole Loan, supported by the Special Servicer, took steps to protect their interest in properties and the operations of Southern Cross. Those actions included the diversion of cash flow, which would otherwise be applied to repay the Libra Whole Loan, to be retained by the obligors for working capital purposes to ensure the transition and continued operation of the properties. This led to the formation of a new company, HC-One Limited on 1 November 2011, which now has direct control of the operations of 239 NHP care homes under new management. Southern Cross thereafter proceeded to a solvent wind down of its operations. All of this was accomplished without the need for the modification of any CMBS transaction documents. The entire situation was quite novel and unusual for a CMBS transaction, but it was a testament as to the flexibility of CMBS transactions to manage distressed scenarios.

In November 2013, after allowing for a significant period for stabilisation in the operation of the properties, the Special Servicer announced that it had commenced a sales process for the borrower group.

Further, the Special Servicer disclosed an updated valuation of the underlying properties of the Libra Whole Loan which demonstrated that the value of the properties had declined to less than 40% of their original valuation. This would mean that the value of the properties had declined so significantly, that there was not likely sufficient value to cover any Class of Notes below Class A.

The facts which gave rise to the issues addressed by the Judgement related to a notice issued to the Note Trustee by Anchorage Illiquid Opportunities Offshore Master III, L.P. ("**Anchorage**"), which was the presumed controlling class representative (being the representative of the most junior class of Notes) that was sent shortly after the announcements made by the Special Servicer. In that notice, Anchorage took action to terminate the appointment of the Special Servicer and

requested that the Note Trustee issue a conditional notice of termination to the Special Servicer, such notice to become effective following satisfaction of all applicable "conditions precedent".

Following the notice of termination issued by Anchorage, a group of class A Noteholders wrote to the Note Trustee expressing their opposition to the conditional termination of the appointment of the Special Servicer. The group was concerned that the "conditions" for termination could not be satisfied and that the effect of such a "conditional termination" would only be to "chill" the sales process that the Special Servicer was trying to complete. Further, they did not want a class of Notes that was currently "out of the money" to manipulate the procedure for termination of the Special Servicer in a manner designed to delay or prevent the sale of the properties or the borrower group.

Faced with a notice from the representative of the most junior class of Notes conflicting with the instructions given by a group of Class A Noteholders, the Note Trustee sought the Court's directions and guidance as to how it should approach the exercise of any discretion that it might have in dealing with an instruction from the Controlling Class Representative to terminate the appointment of the Special Servicer pursuant to the terms of the Servicing Agreement.

The Issues and Arguments of the Parties

The Note Trustee submitted various issues for consideration by the Court in relation to the interpretation of the contractual provisions dealing with the termination without cause of the Special Servicer. These issues included:

- the requirements to obtain rating confirmation, in particular when:
  - Fitch has declined to provide such confirmation and has issued published guidance on this point; and
  - Moody's has declined to provide any confirmation in writing, but has provided verbal feedback with respect to their rating concerns;
- any discretions of the Issuer or the Note Trustee in approving the actual successor special servicer, particularly given the language in the Servicing Agreement that requires that the successor is "approved" by the Issuer and the Note Trustee;
- the applicable mechanics to the termination of the appointment of the Special Servicer, in particular, the rights or discretions of the Note Trustee to issue a "conditional" notice of termination; and
- the requirement to replace the Advance Provider as a precondition to the termination of the appointment of the Special Servicer.

As a result of the issues at hand dealing directly with the conflicting interests of the most junior Class of Notes and the most senior Class of Notes, one of the Class A noteholders (the "**Class A Noteholder Defendant**") joined the proceedings as the Third Defendant on the agreement that, for commercial reasons, it is not to be identified by its name.

An additional query was submitted on behalf of the Class A Noteholder Defendant for consideration by the Court. This query dealt with the actual identity of the Controlling Party and whether or not the reference in the Servicing Agreement to the Controlling Party should be interpreted to mean the Issuer, rather than the holders of the Class E Notes.

In order to address the issue relating to the replacement of the Advance Provider, the Backup Advance Provider joined the proceedings as the Fourth Defendant.

In summary, the arguments put forward on behalf of Anchorage, the Class A Noteholder Defendant and the Backup Advance Provider were as follows:

On behalf of Anchorage:

- the Class E Notes are the Controlling Party on the basis of the disclosure of the Offering Circular which should serve as contractual purpose; it would be commercially absurd if the Controlling Party were to be the Issuer on the basis that the parties must have intended to give a meaningful role to the Controlling Class Representative;
- a rating confirmation from Fitch was not required since Fitch has confirmed in its press releases that it would not provide rating confirmation in relation to the servicers' replacement;
- a rating confirmation from Moody's had to be delivered in writing pursuant to the relevant provisions of the Servicing Agreement;
- notwithstanding the literal wording in the conditions precedent in the Servicing Agreement for a change in the Special Servicer, the Note Trustee did not have a general discretion to approve or refuse to approve the successor special servicer appointed by the Controlling Party; and
- it would make no commercial sense if the termination of the appointment of the Special Servicer were to be dependent on the replacement of the Advance Provider.

On behalf of the Class A Noteholder Defendant:

- the Servicing Agreement and the Intercreditor Agreement clearly state that the Controlling Party is the Issuer;
- a rating confirmation from each of Fitch and Moody's is required as a precondition to the termination of the Special Servicer;
- the confirmation from Moody's is not required to be in writing; and
- the Note Trustee has a general discretion to approve or refuse to approve the successor special servicer appointed by the Controlling Party.

On behalf of the Backup Advance Provider:

- it is clear from the terms of the Servicing Agreement that the termination of the appointment of the Special Servicer is conditional upon the Advance Provider being replaced; this is because the Advance Provider is in a position of commercial vulnerability vis-a-vis the Special Servicer by reason of the role of the Special Servicer being entitled to require that an advance is made by the Advance Provider.

Law on Interpretation of Documents

Much of the Judgement covers the proper construction of the relevant documents. In this regard, the Judgement provides a very helpful and clear framework for construction of documents and interpretation of provisions.

The Judge referred to well-known authorities on interpretation of commercial document in order to rely on the ordinary meaning of the words of the Servicing Agreement. From them, he summarised the following:

"i) The interpretation of a contract is an objective exercise in which the court's task is to ascertain the meaning that the document would convey to a 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.

ii) This exercise of interpretation was described by Lord Clarke in Rainy Sky [SA v Kookmin Bank [2011] 1 WLR 2900] as a "unitary" process. The starting point of that process must be the ordinary, natural and grammatical sense of the language used by the parties. The court should not, however, confine itself to a consideration of such language in isolation, but should carry out an iterative process, checking each of the rival meanings of the provision in question against the other provisions of the document and its overall scheme, and investigating their commercial consequences.

iii) If as a consequence of this exercise the court concludes that the language used is unambiguous, then the court must apply it, even though some other result might be thought more commercially reasonable, and even if it gives a result that is commercially disadvantageous to one of the parties. The court's function is to interpret the contract, not to rewrite it.

iv) In cases where the language used is ambiguous, in the sense that it is capable of bearing more than one ordinary and natural meaning, the court is entitled to prefer the interpretation that is most consistent with business common sense having regard to the commercial purpose of the transaction.

v) There may be cases where, even though the language used is unambiguous, it is clear that something must have gone wrong, because the resultant meaning is one that would require the court to attribute to the parties an intention that they plainly could not have had. In such a case, if it is clear both that a mistake has been made in the language used and what a reasonable person would have understood the parties to have meant, the contractual provision must be interpreted in accordance with that meaning."

The Identity of the Controlling Party

The first issue addressed by the Court was in relation to the identity of the Controlling Party and arose as a result of the discrepancy in the definition of "Controlling Party" in the Servicing Agreement which made reference to the Controlling Party being "the Representative for the A Loan" and the definition of "Controlling Party" in the Offering Circular which made reference to the Controlling Party being the "Controlling Class Representative", which would be the entity appointed by the Class E Notes.

In addressing this first issue, the Judge relied on the basic principal of interpretation of contract, in particular, the principle that if "*the language used is unambiguous, then the court must apply it, even though some other result might be thought more commercially reasonable, and even if it gives a result that is commercially disadvantage to one party*." The Judge submitted a detailed analysis of the provisions of the Servicing Agreement, the Intercreditor Agreement and the Master Definitions Schedule, which analysis supported that there was no apparent mistake in the contractual documents and that a reference to the Controlling Party being the Representative for the A Loan was a reference to the Issuer being the Controlling Party.

The key analysis of the Judge was based on the fact that the Offering Circular is not a contractual agreement and that if the underlying contractual documents do not accord with the disclosure of the Offering Circular, the ordinary meaning of the contractual documents must take precedent over the disclosure in the Offering Circular. This is particularly consistent with the disclosure in the Offering Circular which stated that "*The obligations of the parties to the transactions contemplated herein are set forth in and will be governed by certain documents herein, and all of the statements and information contained herein are qualified in their entirety by reference to such documents*."

The Judge highlighted that although the Offering Circular "*is undoubtedly an important part of the relevant matrix against which the Servicing Agreement must be construed*", the Offering Circular is not a contractual document and that the relevant disclaimer in the Offering Circular minimised any force that the Offering Circular may have as an aid to construct the Servicing Agreement.

The Judge further noted that the result of having the Issuer as the Controlling Party is not a conclusion that is commercially absurd nor is it, as per the arguments presented on behalf of Anchorage, a mistake in the drafting of the Servicing Agreement.

On this first issue, the Judge's conclusions were that since the reference to the Controlling Party being the Representative of the A Loan in the Servicing Agreement was unambiguous and further, consistent with the provisions of the Intercreditor Agreement and the Master Definitions Schedule, the Controlling Party is not the Controlling Class Representative but is the Issuer or, as a result of the security assignment pursuant to the Deed of Charge, the Note Trustee.

The Judge concluded on this first issue by noting that the role of the Controlling Party moved up the tranches of the Subordinated B Loan as those tranches fell successively underwater. However, he noted that Anchorage presented no arguments to support an interpretation that once the value broke in the Libra Loan, the Controlling Party should be and remain the most junior class of Notes, irrespective of which class of Notes might be most directly affected by the decision of the Special Servicer. This analysis of the Judge is consistent with the position recently adopted by the CREFC CMBS 2.0 principles which support the Controlling Class being the most junior class of Notes that remains still "in the money".

Rating Agency Confirmation

The Judgement dealt with the well-known issue relating to the issuance of rating agency confirmations, in particular in the context where certain Rating Agencies decline to provide such rating confirmation.

The Judge referred to the Fitch press releases which stated that Fitch will not provide rating agency confirmation in relation to a special servicer's replacement. As the requirement to obtain a rating confirmation from Fitch is common in many of the securitisations arranged between 2005 and 2007, this issue of the Fitch rating confirmation has been the centre of many discussions relating to special servicer replacements.

The Judge relied on a provision in the Servicing Agreement which provided that if the Servicing Agreement requires the Servicer or Special Servicer to obtain a rating agency confirmation, and a Rating Agency declined to issue such confirmation, then the provision should be read and construed as though such confirmation is not required and the Servicer or Special Servicer may proceed with the matter in question without obtaining such rating confirmation. It should be noted that while such a provision is recommended by the CREFC CMBS 2.0 principles, this provision was not commonplace in European CMBS transactions before 2011.

The Judge relied on this provision in that it gave a clear indication of the commercial intention of the parties in the event that a Rating Agency stopped issuing rating confirmations. The Judge noted that it would not make any commercial sense for the parties to have agreed that the Servicer or Special Servicer could no longer be terminated (nor even terminate their respective appointment) if one Rating Agency declined to provide a confirmation in circumstances where the other two Rating Agencies were willing to give such confirmation.

In relation to the rating confirmation from Moody's, the Judge concluded that even if there is no specific reference to a rating confirmation to be provided in writing by Moody's in the Servicing Agreement and the Master Definitions Schedule, there is a clear requirement under the Servicing

Agreement for each Rating Agency to be notified and, provided that it has not declined to provide a rating confirmation, provide the required confirmation whether verbally or in writing.

Approval of the Successor Special Servicer

In connection with the issue relating to the approval of the successor special servicer by the Issuer and the Note Trustee, the Judge discussed the exercise of the Note Trustee's discretion to approve the successor special servicer. In particular, the Judgement considered whether the Note Trustee has the ability to exercise any discretion when taking into account the proposed successor's experience in servicing mortgages on similar terms to the Servicing Agreement, and other considerations such as the commercial interest of the Noteholders.

The actual wording of the Servicing Agreement provided as follows:

> "No termination of the Servicer's or the Special Servicer's appointment under Clauses 22.1 (Servicer Events of Default), 22.2 (Termination by the Controlling Party) or 22.4 (Voluntary Termination) shall take effect unless:
>
> . . . .
>
> (c) . . . [the] successor Servicer or Special Servicer, as applicable, has experience in servicing mortgages of commercial property on similar terms to that required under this Agreement **and is approved by the Issuer and the Note Trustee** (such approval in each case not to be unreasonably withheld)."

The Judge concluded that the Servicing Agreement provided for two separate requirements that must be satisfied before the termination of the appointment of the Special Servicer can take effect, in that the successor special servicer must have the relevant experience and separately the Issuer and the Note Trustee must approve the successor. Therefore, the Issuer and the Note Trustee can decide to withhold approval on the grounds that, even if the successor special servicer is suitably experienced, it is, for example, incompetent or insolvent or in regulatory difficulties.

Rather than providing a list of grounds for consideration by the Note Trustee and the Issuer, the Judge noted that the Issuer or the Note Trustee might take into account in the exercise of their discretion, the provisions in the Note Trust Deed or the other transaction documents that provide that, in the event of any conflict of interest, the interests of the more senior Notes will always prevail over the interest of any more subordinate class of Notes.

It should be noted here that the provision above is a standard provision contained in many servicing agreements for CMBS transactions.

Replacement of the Advance Provider

A further condition to the termination of the Special Servicer under the Servicing Agreement was that the Advance Provider be replaced with a suitable replacement subject to and in accordance with the terms of the Servicing Agreement.

The Judge concluded that the appointment of the Special Servicer cannot be effectively terminated unless the Advance Provider is replaced at the same time. The background to the commercial intention behind this clause was considered relevant as the Special Servicer and Advance Provider were all originally in the same group of companies and the Advance Provider's obligation to make an advance is solely dependent on the Special Servicer's determination of recoverability of such advance.

The Judge further concluded this issue by holding that as the request for the requirement for the replacement of the Advance Provider is inserted for the benefit of the Advance Provider, there are grounds for suggesting that the condition could be waived by the Advance Provider if it was willing

to remain in office with the new Special Servicer. However, the Judge did not discuss whether such waiver could be given by the Advance Provider alone or would require the consent of the Backup Advance Provider.

Mechanics of Termination of the Appointment of the Special Servicer

To address the issue as to whether a notice of "conditional" termination should be issued upon receipt of a notice of termination by the Controlling Party, the Judge held that the Controlling Party is entitled to give written notice to the Note Trustee to require the Note Trustee to terminate the appointment of the Special Servicer. Further, upon such notice being given, the Note Trustee must act to terminate the appointment of the Special Servicer. However, the Note Trustee is under no express obligation to serve a "conditional" termination notice on the Special Servicer.

In particular, upon receiving a notice of termination of the Special Servicer from the Controlling Party, the Note Trustee should take the necessary steps to confirm that the preconditions to the termination of the Special Servicer have been satisfied.

If, while taking such steps, it becomes clear that the preconditions will not be satisfied, the Note Trustee would not be obliged to serve a termination notice. In the event that the preconditions to termination are satisfied, the Note Trustee would be obliged to serve an unconditional notice of termination of the Special Servicer.

The Judge did not address the issue as to when the Note Trustee might actually serve a notice of "conditional" termination. He indicated that when the preconditions were reasonably certain to be achieved, it might be desirable to give advance notice of the termination. However, for the same reasons he did not address the factors that may be taken into consideration by the Issuer and the Note Trustee in exercising their discretion to approve the successor special servicer, the Judge did not consider these issues in further detail.

Conclusions

The Judgement provides clear guidance on the termination without cause of the appointment of a servicer, subject to certain contractual preconditions being met. In particular, it addresses the discretion that the Issuer and the Note Trustee have in the approval of the successor special servicer and the circumstances in which a rating agency confirmation is not required.

Also, the Judgment addresses the issues of discrepancies between an offering circular and the contractual securitisation documents by confirming that if there is no ambiguity or error within the contractual securitisation documents, a contrary disclosure in the offering circular should not serve as an aid to interpretation to modify the terms of such contractual securitisation documents.

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[1] US Bank Trustees v Titan Europe 2007-1 and others [2014] EWHC 1189 (Ch) available at http://www.bailii.org/ew/cases/EWHC/Ch/2014/1189.html.

[2] At the time of publication of this article, none of parties to the Claim filed any request for an appeal.

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