PAUL HASTINGS

STAY CURRENT

August 2015

Follow @Paul_Hastings

High Court Ruling Provides Further Guidance on CMBS Special Servicer Replacement

By Charles Roberts, Michelle Duncan & Stephen Parker

On 31 July 2015, Mr Justice Arnold delivered his judgment (the "Judgment") on the directions sought by Deutsche Trustee Company Limited (the "Note Trustee") in relation to the replacement of the special servicer on the DECO 15—Pan Europe 6 Limited CMBS transaction ("DECO 15").[1] The Judgment centred on the interpretation of certain contractual provisions of the servicing agreement in relation to replacement of the special servicer and their interaction with the current position of certain rating agencies (in particular Fitch) in relation to providing rating agency confirmations.

The Judgment provides further guidance in this area following an earlier judgment in *US Bank Trustees Limited v Titan Europe 2007-1 (NHP) Limited and others* (the "Titan (NHP) Judgment"),[2] which was analysed in a previous Stay Current in April 2014.[3] The Titan (NHP) Judgment also considered various issues around the replacement of a special servicer, including the approach to be taken in relation to the interpretation of contractual provisions concerning rating agency confirmations.

Background

In DECO 15, DECO 15—Pan Europe 6 Limited (the "Issuer") issued commercial mortgage floating rate notes (the "Notes") in a total amount of €1,445,342,232 in ten classes from Class A1 to Class G. The proceeds of the issue of the Notes were used to purchase interests in a total of ten loans (the "Loans").

Each class of Notes are rated by one or more of three rating agencies (the "Rating Agencies"): Moody's Investors Services Ltd ("Moody's"); Standard & Poor's Rating Services, a division of the McGraw-Hill Companies, Inc ("S&P"); and Fitch Ratings Ltd ("Fitch").

Under the transaction documents for DECO 15 (the "Transaction Documents"), there is provision for a "Controlling Class" of Notes, being the most junior ranking class of Notes with at least 25% of its original principal amount outstanding. The holders of the Class G Notes, as the most junior class of notes, were the Controlling Class as at the closing date, and are still the Controlling Class. In addition, the Controlling Class is entitled to appoint a Noteholder to be their representative (the "Operating Advisor").

As is standard in CMBS transactions, the Issuer appointed a servicer (the "Servicer") and a special servicer (the "Special Servicer") to administer and manage the Loans that formed part of DECO 15 on its behalf pursuant to a servicing agreement (the "Servicing Agreement"). Whilst a Loan is performing, the Loan is managed by the Servicer, whose role is limited to cash collection, receipt of information and reporting. However, once a Loan defaults, a "Special Servicing Transfer Event"

occurs and the management of the Loan transfers to the Special Servicer, who has a much wider remit to determine the options for resolving the default or enforcing the security for the Loan so as to maximise recoveries in relation to the Loan.

Replacement of the Special Servicer

Pursuant to the Servicing Agreement, the appointment of the Special Servicer could be terminated in certain specified circumstances. These circumstances included (pursuant to clause 26.3 of the Servicing Agreement, "clause 26.3") where the Operating Advisor notifies the Issuer that it requires a replacement Special Servicer to be appointed. However, the right of the Operating Advisor to require the replacement of the Special Servicer was qualified by a proviso that the termination of the appointment of the Special Servicer in this way would not cause the then current rating of the Notes to be downgraded, withdrawn, or qualified.

Clause 26.3 was further qualified by clause 26.4, which provided in subparagraph (b) ("clause 26.4(b)") that no termination of the Special Servicer under clause 26.3 was to take effect unless:

> *The [Servicer] or, as the case may be, the [Special Servicer] will have notified each of the Rating Agencies in writing of the identity of the successor [Servicer] or successor [Special Servicer] and the Rating Agencies have confirmed to the Issuer Security Trustee and the Note Trustee that the appointment of the successor [Servicer] or [Special Servicer] will not result in an Adverse Rating Event, unless each class of Noteholders have approved the successor [Servicer] or successor [Special Servicer], as applicable, by Extraordinary Resolution;*

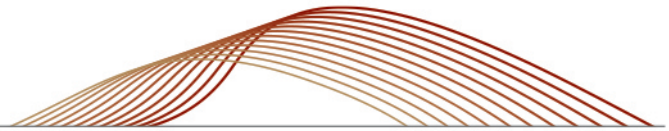
An "Adverse Rating Event" was defined in the Transaction Documents as meaning "*with respect to any Rating Agency, an event that would cause the downgrade, qualification or withdrawal of the then current ratings by such Rating Agency of any class of Notes.*"

Confirmations by the Rating Agency

Clause 29.13 of the Servicing Agreement ("clause 29.13") sets out specific requirements in relation to confirmations from the Rating Agencies as follows:

> *If this Agreement requires Rating Agency confirmation to be obtained in relation to a particular matter, the [Servicer] (or, in the case of matters pertaining to a Specially Serviced Loan, the [Special Servicer]) will, as soon as is practicable following a request therefor, provide each Rating Agency with all information as is reasonably necessary and available to it to enable such Rating Agency to determine whether, and on what basis, confirmation should be given. In the event that Moody's fails to respond to such request for confirmation within 30 days (or such earlier date as the [Servicer] or the [Special Servicer], as applicable, has determined is appropriate under the circumstances in accordance with the Servicing Standard), the [Servicer] or the [Special Servicer] will not be required to obtain such confirmation from Moody's.*

In about 2007, Moody's generally stopped providing written confirmations in relation to CMBS transactions. On 10 December 2012, Fitch issues a press release stating that it would not provide rating confirmations in EMEA CMBS. The reason for this stance was expressed to be concerns regarding proposals originating from individual classes of noteholders that may not be aligned with those of other noteholders. Fitch specifically identified replacing a special servicer as one area where such conflicts of interest could arise.



Request to Replace the Special Servicer and the Issue in the Proceedings

On 22 May 2014, Cheyne Capital (Management) UK (LLP) ("Cheyne"), who had previously been appointed as the Operating Advisor on DECO 15, requested that the Issuer terminate the appointment of the current Special Servicer (Hatfield Philips International Limited) on two of the smaller Loans and appoint a replacement Special Servicer, namely Solutus Advisors Ltd. This request was made pursuant to clause 26.3.

The Rating Agencies were notified of Cheyne's request and the required confirmation was received from S&P, whilst Moody's said that it would be able to provide a confirmation contemporaneously with the Special Servicer being replaced. However, in line with its stated policy, Fitch stated that it would not respond to any request to provide a rating confirmation and so no confirmation was (or would be) received from Fitch (although Fitch has also not indicated that the replacement would result in an Adverse Rating Event).

In those circumstances, the issue that arose to be determined by the Court was whether clause 26.4(b) permits the replacement of the Special Servicer in circumstances where a Rating Agency declines to say whether or not the appointment of the proposed successor Special Servicer would result in an Adverse Rating Event.

At the hearing, Cheyne argued for its favoured construction of clause 26.4(b). Whilst the Note Trustee was neutral in relation to the outcome of the proceedings, it agreed to advance the alternative argument on behalf of other Noteholders who might be affected.

The Key Features of the Relevant Provisions

Before turning to the arguments advanced by Cheyne and the Note Trustee, it is helpful to bear in mind some key features of the relevant provisions.

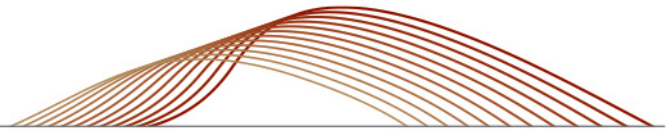
The condition for a Special Servicer to be replaced under the provisions of the Servicing Agreement (including clause 26.3) contained in clause 26.4(b) contains two limbs:

- The first limb requires the Rating Agencies to have been notified of the identity of the successor Special Servicer and to have confirmed to the Note Trustee that the appointment will not result in an Adverse Rating Event.
- The second limb provides for an exception to the first limb, whereby an Extraordinary Resolution of Noteholders could approve the successor Special Servicer being appointed.

The provision in clause 29.13 that sets out further detail in relation to how confirmations from Rating Agencies are to obtained includes a specific provision in relation to confirmations sought from Moody's, whereby if Moody's fails to respond to a request within 30 days no confirmation from Moody's will be required. However, this provision does not specifically address the issue of the other two Rating Agencies not providing a confirmation.

The Arguments Advanced by the Parties and the Decision of the Judge

In considering the arguments advanced by the parties, the Judge noted the summary of the principles for the interpretation of commercial documents in the Titan (NHP) Judgment and in particular observed that interpretation is an iterative process, starting from the ordinary, natural, and grammatical sense of the language used by the parties but then checking each rival interpretation against other provisions in the document and the overall scheme and also investigating the commercial consequences of each interpretation. The Judge adopted this iterative process and analysed each argument advanced by the parties in stages. The key arguments



advanced by the parties, together with the Judge's reasoning and conclusions are summarised below.

First, the Judge considered the first limb of clause 26.4(b). Cheyne argued that the wording of this limb did not address the problem of one of the Rating Agencies refusing to provide the confirmation required. As it did not make sense to require a confirmation that would not be forthcoming, the provision should be interpreted as only requiring confirmations from those Rating Agencies that were willing to provide them. However, the Note Trustee argued that the wording of this limb is perfectly clear and all three Rating Agencies must provide the required confirmations.

The Judge considered that as a matter of language, the Note Trustee's interpretation of clause 26.4(b) was to be preferred as the natural one; Cheyne's interpretation of the clause did not reflect what the words actually said. However, in reaching this conclusion, the Judge recognised that requiring a Rating Agency to provide a confirmation where the Rating Agency had adopted a policy of not providing confirmations was not sensible. This led to the Judge considering the second limb of clause 26.4(b).

Second, the Judge considered the second limb of clause 26.4(b). Cheyne argued that this limb cannot have been intended to provide an alternative route to obtaining confirmations from Rating Agencies that are willing in principle to give them and is not a satisfactory answer to the problem of Rating Agencies not giving confirmations. The Note Trustee argued that this limb provides an answer to the problem that Cheyne says arises in relation to the first limb.

After considering the arguments advanced by the parties, the Judge came to the conclusion that the second limb of clause 26.4(b) does provide an answer to the problem with the first limb.

Third, the Judge considered the relevance of clause 29.13. Cheyne argued that the specific provision in clause 29.13 relating to Moody's was designed to address the known problem with Moody's and did not address the possibility of other Rating Agencies adopting policies of not providing confirmations at a later date, although it did show how the parties contemplated such a problem should be addressed. The Note Trustee argued that the provision relating to Moody's was inconsistent with Cheyne's interpretation of clause 26.4(b), as it showed that the draftsman had specifically addressed the question of a confirmation not being provided by a Rating Agency and made provision for this eventuality in the case of Moody's.

The Judge rejected Cheyne's arguments in relation to clause 29.13, observing that it would have been easy for the clause to refer to any Rating Agency failing to respond instead of only referring to Moody's. Therefore, Cheyne's interpretation of this clause would amount to re-writing it.

Fourth, Cheyne argued that the proviso to clause 26.3 supported its interpretation of clause 26.4(b), as the appointment of a successor Special Servicer would be ineffective if there is subsequently an Adverse Rating Event, which meant that senior Noteholders were protected and so there was no need for a confirmation in advance.

The Judge also rejected Cheyne's argument on this point. In particular, the Judge noted that if Cheyne's interpretation was correct and sufficient protection was provided to senior Noteholders by clause 26.3, there would be no point in having clause 26.4(b). The Judge inferred that the requirement in 26.4(b) was therefore to avoid, so far as possible, the possibility of an Adverse Rating Event occurring after a successor Special Servicer is appointed and hence the replacement being ineffective. Further, the Judge considered that an Adverse Rating Event would be prejudicial even if the appointment of the successor Special Servicer is reversed. Finally, the Judge was concerned as to what would happen in the interim period between the successor Special Servicer

being appointed and that appointment becoming ineffective due to an Adverse Rating Event—who would service the Loan in that period?

Finally, the Judge considered the question of commercial absurdity. Cheyne argued that it is commercially absurd to require a confirmation from a Rating Agency that has adopted a policy of not giving such confirmations. The Note Trustee argued that it is commercially absurd to construe clause 26.4(b) such that it operates solely where one or more Rating Agencies respond by saying that the appointment would result in an Adverse Rating Event.

The Judge was not persuaded by the arguments as to commercial absurdity. In particular, the Judge observed that the second limb of clause 26.4(b) provided a get-out to the potentially commercial absurd result that Cheyne argued would exist.

Having completed this iterative process, taking each argument in turn, the Judge concluded that the interpretation of clause 26.4(b) advanced by the Note Trustee was the correct one.

Conclusions

The Judgment provides a valuable follow up to the Titan (NHP) Judgment on the important question of Rating Agency confirmations and the replacement of special servicers. From the Judge's analysis, two points are clear.

First, the wording of the specific servicing agreement under which the replacement is to take place is crucial in determining the approach to be taken to Rating Agency confirmations not being provided. Therefore, there is not one answer to this issue; the question needs to be considered afresh, each time based on a careful analysis of the wording of the specific servicing agreement. In this regard, the Judge was not assisted by the conclusion in the Titan (NHP) Judgment as to whether a Rating Agency confirmation was required in that case, as the wording of the servicing agreement was different to that in DECO 15.

Second, the Judgment once again underlines the limit of commercial arguments in interpreting transaction documents in complex financings. Whilst judges will test the literal interpretation of a provision against its commercial effect, care must be taken not to follow such reasoning too far. If an interpretation based on the normal meaning of the words can be found that works commercially as well, a judge will tend to favour that interpretation, notwithstanding that another interpretation that does more violence to the wording of the contract would be more commercial.

✧ ✧ ✧

If you have any questions concerning these developing issues, please do not hesitate to contact any of the following Paul Hastings London lawyers:

Michelle Duncan
44.020.3023.5162
michelleduncan@paulhastings.com

Stephen Parker
44.020.3023.5168
stephenparker@paulhastings.com

Charles G. Roberts
44.020.3023.5164
charlesroberts@paulhastings.com

[1] *Deutsche Trustee Company Limited v Cheyne Capital (Management) UK (LLP) and another* [2015] EWHC 2282 (Ch), available at http://www.bailii.org/ew/cases/EWHC/Ch/2015/2282.html.

[2] [2014] EWHC 1189 (Ch), available at http://www.bailii.org/ew/cases/EWHC/Ch/2014/1189.html.

[3] Available at http://www.paulhastings.com/docs/default-source/PDFs/stay-current-article-on-titan-europe-2007-1.pdf.