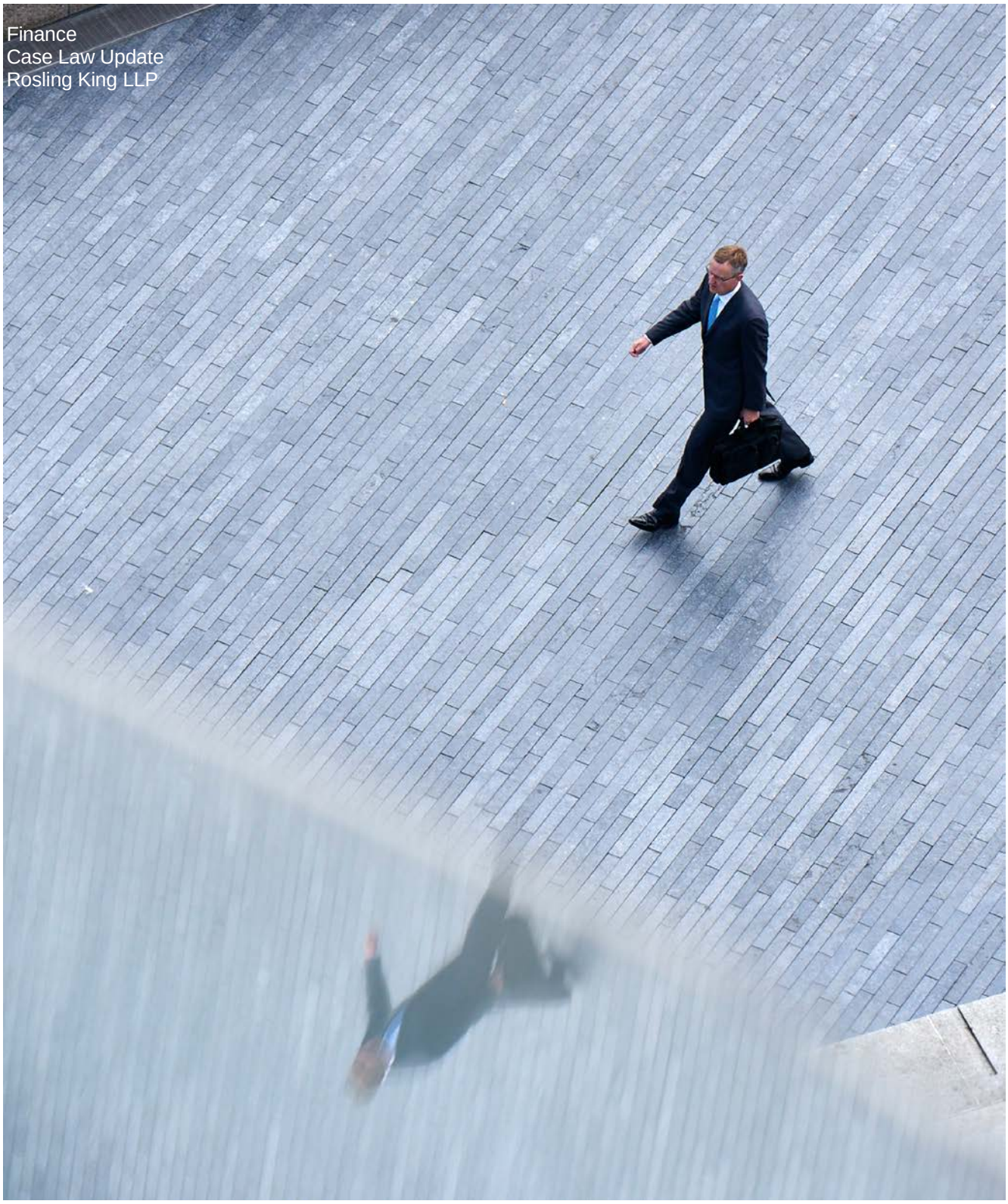
Finance
Case Law Update
Rosling King LLP



## Introduction

In the latest set of cases to analyse the structure of legacy Commercial Mortgage Backed Securities ("CMBS"), the High Court in London has examined the entitlement of 'Class X' noteholders to payments of principal and interest.

The 4 cases in question were each brought by Credit Suisse Asset Management ("CSAM"), which is the investment manager of a fund which holds the Class X notes in four securitisation structures, Titan Europe 2006-1 ("Titan 2006-1"), Titan Europe 2006-2, Cornerstone Titan 2007-1 and Titan Europe 2007-2.

The judgment delivered by the Court in the 'Titan Cases' only considered Titan 2006-1, however it was applied to the four sets of proceedings relating to each of the securitisation structures, on the basis that the transaction documentation across all four structures was identical.

## What is Class X?

Class X notes in legacy CMBS structures were created as a means of returning the 'excess spread' (i.e. any surplus cash flow arising from the underlying loan after the payment of all interest payable to the other classes of noteholder and expenses of the deal) to the holder of the Class X note. The Class X note was ordinarily retained by the originating lender, albeit that the Class X notes were tradeable instruments.

Class X notes had a low nominal value (in the case of Titan 2006-1, this was EUR 50,000) and paid a variable rate of interest pari passu with the Class A notes. Whilst the underlying loans in a CMBS continued to perform, there was little criticism of how the Class X operated. However, as the loans started to default, other classes of note suffered losses whilst the Class X continued to receive substantial payments (in the case of Titan 2006-1, the 'Class X Interest Rate' ranged from 9,024 per cent to 114,508 per cent). Issues have since arisen as to how the 'excess spread' should be determined.

## The Issues

There were essentially two key issues to be determined by the Court in the Titan Cases:

Firstly, should the 'Class X Interest Rate' which was payable to the Class X noteholders take into account default interest which was payable by the borrowers under the underlying loan; and

Secondly, whether the Class X Notes ought to be redeemed immediately or whether they should remain outstanding pending redemption of all of the other classes of note (in which case, interest would continue to be payable on the Class X Notes).

## The Decision

In respect of the first issue, the Court analysed the definition of 'Class X Interest Rate', and in particular whether, as CSAM contended, the wording "*the related per annum interest rate due on such Loan*" included an additional, or default, rate of interest payable in the event of the

default of an underlying loan.

The Judge rejected CSAM's arguments and concluded that no account should be taken of any default interest which was payable under the underlying loans. Central to the Judge's eight-point finding was the notion that "*the effect of including default interest in the calculation of* [the Class X Interest Rate] *is that the worse the Loans perform the higher proportion of the Loan income is payable to the Class X Noteholder. That is counter-intuitive bearing in mind that the Class X Notes represent the financial reward to the Originator of the structured note offering, which was intended to attract investors on the basis that the Loans were sound and shown to be such by favourable Moody's ratings for the Notes*". He further made the point that there was an "*absence of any indication in the Offering Circular that the Class X Notes would perform in that way in the event of default*".

In respect of the second issue, the Court held that the Class X Notes must be immediately redeemed. The relevant contractual provision stated that "*unless previously redeemed in full and cancelled ….. the Issuer shall redeem the Notes at their Principal Amount Outstanding together with accrued interest at the Maturity Date, which is the Payment Date falling in January 2016*". In the case of Titan 2006-1, EUR 45,000 of the nominal EUR 50,000 had already redeemed, leaving an outstanding EUR 5,000 which had at all times been held in a segregated account. Given his decision in respect of the first issue, the Judge concluded that it must follow that the Class X Notes must be redeemed immediately. He held that it was highly unlikely to have been intended that even though "*(1) the Originator never risked any capital for the purchase and subsequent non-performance of the Loans, (2) its outlay was limited to a mere EUR 50,000, (3) that sum was placed in a separate account reserved for its repayment, (4) EUR 45,000 was repaid on the first Payment Date, and (5) the remaining EUR 5,000 is available for redemption of the Class X Notes, nevertheless the Class X Notes would remain in existence for an indefinite period creaming off payments from the borrowers to meet the Class X Noteholders' entitlement at the top of the waterfall, an entitlement which is proportionately higher than it would have been if there had been no default under the Loans*".

## Conclusion

The Titan Cases represent the latest blow to Class X noteholders who have sought to benefit from defaulting CMBS structures. These cases also demonstrate a further willingness from the Courts to look behind some of the inadequacies in the transaction documentation in legacy CMBS deals in order to ensure that the intentions of the original deal parties are honoured.

For further information, please contact James Walton or the Partner with whom you usually deal.