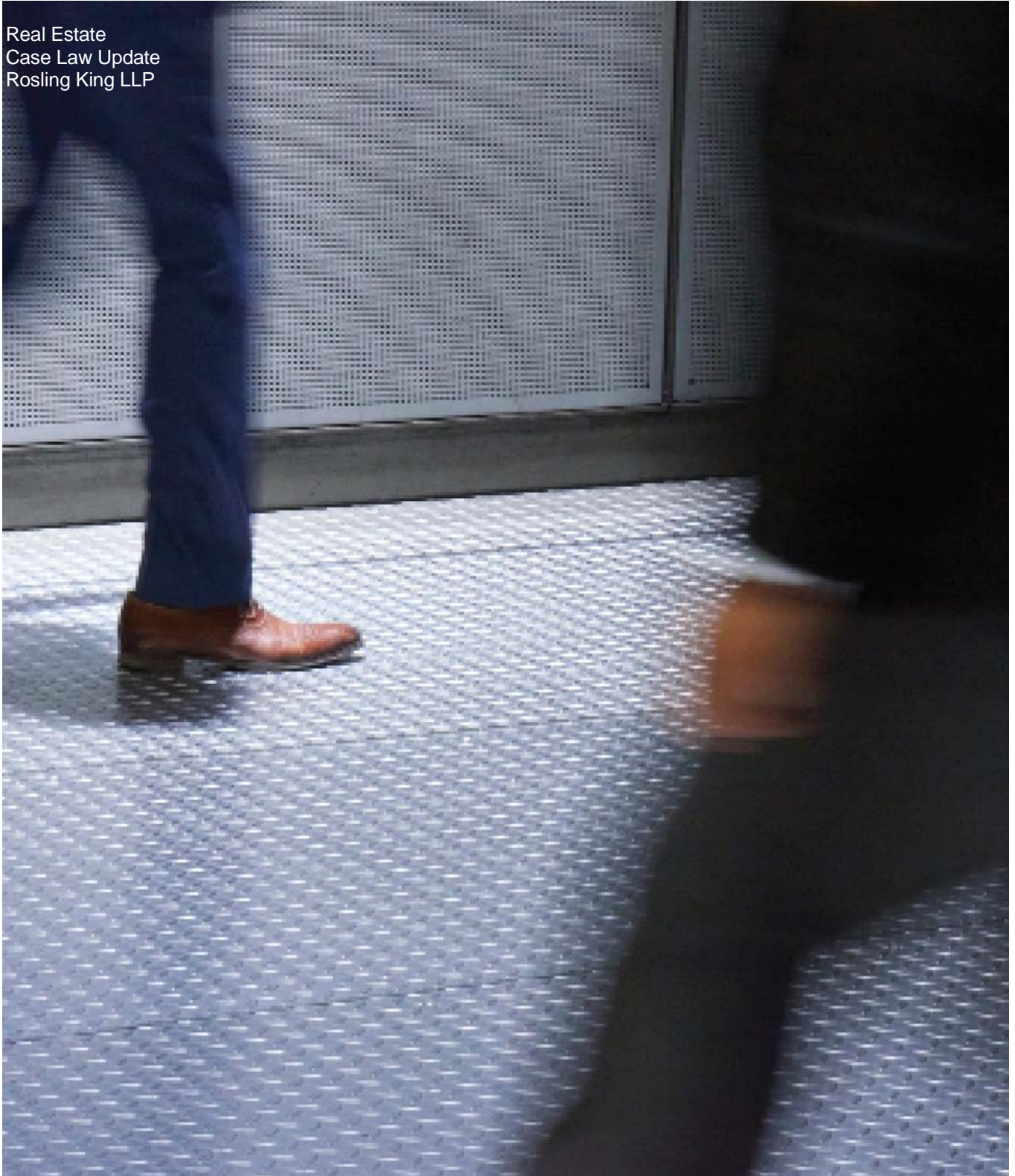


Real Estate  
Case Law Update  
Rosling King LLP



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Sale proceeds from the 36 UK commercial properties underlying the £850m Gemini CMBS issuance should be treated as principal rather than interest, the High Court has held, meaning the class A noteholders have an entitlement to these receipts ahead of their junior counterparts.

### Background

The claimant, CBRE Loan Servicing Limited (“CBRE”), acted as master servicer and special servicer of a securitised bank loan of £918,862,500 (the “Loan”) advanced by Barclays Bank Plc (“Barclays”) to a number of Guernsey-registered limited partnerships. In November 2006, Gemini (Eclipse 2006-3) Plc (the “Issuer”) purchased the Loan and related security by issuing £918,862,000 secured floating-rate notes, divided into classes A to E (the “Notes”).

A substantial fall in the value of the underlying portfolio of properties together with a failure by the borrowers to pay interest under the Loan led to CBRE accelerating the Loan on 6 August 2012. Administrators and receivers were subsequently appointed over the general partners of the borrowers and the properties which secured the Loan. CBRE also entered into a supplemental hedging arrangement with Barclays whereby Barclays agreed not to terminate certain interest rate hedging transactions.

Rental income collected by the administrators and receivers was paid over to CBRE and applied by CBRE in payment of the periodical payments due under the hedging transactions with Barclays, with the surplus being paid over to the Issuer. Some of the properties which stood as security for the Loan were also sold in accordance with a disposal programme agreed with Barclays.

### The Issue

The question which arose for determination was how rental income and asset sale proceeds (including surrender premiums) should be characterised by CBRE. The governing ‘Cash Management Agreement’ gave no guidance on this point and the terms “principal” and “interest” were undefined. If the receipts constituted “principal”, the holders of the class A Notes would have an entitlement to those monies before the other classes of Notes. It was therefore in the economic interest of the class A noteholders that the sale proceeds and surrender premiums be categorised as principal and in the economic interest of the junior noteholders to argue that these receipts should be classified as interest

### The Arguments

It was generally accepted by the parties that rental income generated by the portfolio of properties should be characterised as interest. The focus of proceedings was therefore on how sale proceeds (and surrender premiums) should be treated.

The junior noteholders argued that the absence of express provision in the Loan documentation dealing with the characterisation of receipts meant, necessarily, that asset sale proceeds and surrender premiums should be applied as interest and distributed across the investor base, according to the common law rule relating to appropriation of payments made to a creditor by his debtor.

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The class A noteholders, however, submitted that the realisations should be considered as principal, arguing this to be in line with what the parties had intended at the time of issue.

#### The Decision

Mr Justice Henderson found the lack of definition of “principal” or “interest” in the Loan documentation to indicate that their determination “was not envisaged as one requiring any legal sophistication, but merely the application of commercial common sense” and that receipts should be characterised as principal or interest depending on their source and the role which they played in the context of the Loan and its security. Accordingly, it was found that sale proceeds should be classified as principal because “they represent the realised capital value of a property which stands as security for the Loan”.

The ruling of Mr Justice Henderson means the class A noteholders have an entitlement to sale proceeds and surrender premiums in priority to the junior noteholders.

#### Commentary

This ruling brings to a close the long running dispute between the senior, class A noteholders and their junior, class B to E counterparts, as to how sale proceeds and surrender premiums should be characterised and allocated. Although the outcome was perhaps unsurprising, and although the decision turned on the facts of this particular case, this decision will provide guidance on how to apply sale proceeds on deals where the wording is similarly ambiguous.

This case is the latest of a number of cases involving CMBS structures to go before the Courts in recent months; indeed the Gemini (Eclipse 2006-3) CMBS transaction is itself still the subject of a substantial valuer negligence claim worth £172.9m being pursued by the Issuer against both CBRE and Warwick Street (KS) LLP, formerly known as King Sturge.

For a summary of recent cases in the real estate finance sector which serve as a reminder of the importance of clear and unambiguous drafting in complex finance structures, please see Rosling King’s article in the October edition of Real Estate Capital Magazine [here](#).

For further information, please contact [James Walton](#) or the Partner with whom you usually deal.