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REGULATORY NEWS AND CASE UPDATES FROM BROWN RUDNICK'S EUROPEAN INSOLVENCY AND LITIGATION PRACTICE GROUPS

THIS BULLETIN COMPARES THE DIFFERENT TREATMENT GIVEN BY COURTS TO CASHFLOW WATERFALLS IN ENFORCEMENT SCENARIOS.

SUPREME COURT APPLIES PARI PASSU PRINCIPLE ON INSOLVENCY DESPITE CLEAR CONTRACTUAL INTENTION TO THE CONTRARY: RE SIGMA FINANCE CORPORATION ('SIGMA') [2009] UKSC 2

In Sigma, the Supreme Court has provided a stark warning that, absent clear and unequivocal language to the contrary, the presumption of *pari passu* application of proceeds will apply on an insolvency. The Supreme Court has applied a tortuous interpretation of a contract (which, on a natural reading, provided for a specified order of application of assets), in order to rule in favour of the court's 'strong instinctive feeling' of a *pari passu* application of assets on a debtor's insolvency.

Whilst the Court's decision was not expressed so much as a rigid application of insolvency principle, but rather its view of the parties' commercial intentions following its review of the contract as a whole, and in the face of what it regarded as certain 'infelicities' in the drafting of the critical clause, investors may find that a waterfall which is quite different to their intentions applies on an insolvency of a debtor.

A brief summary: the debtor, Sigma, had issued short term securities to investors and used the proceeds thereof to buy longer term securities, and the income from the longer term securities was to be used to pay the coupons due to its investors - as per a typical SIV structure. By way of a security trust deed, Sigma charged its assets in favour of the investors. Sigma subsequently became insolvent and this triggered an 'Enforcement Event' under the security trust deed. Sigma's liabilities grossly outweighed its assets.

The security trust deed provided that, on an Enforcement Event, a 60-day 'Realisation Period' would be triggered and the Security Trustee was entitled to dispose of Sigma's assets in such manner as it deemed appropriate in order that it may establish discrete pools of assets by the end of that period. Further, and critically, during the 60-day Realisation Period, the Security Trustee was required to:

> *'so far as possible, discharge on the due dates therefor, any Short Term Liabilities falling due for payment during such period, using cash or other realisable or maturing Assets of the Issuer'.*

The creditors whose debts fell due for payment outside the above provision argued that it was not intended to apply on an insolvency. The Supreme Court agreed, relying in part on the fact that the critical clause did not specifically state that it was to apply on an *insolvency* Enforcement Event. This was so notwithstanding that the Court acknowledged that 'in practice, no doubt, an Enforcement Event would be more likely than not to result from some financial difficulty on Sigma's part'.

With the vast volume of leveraged finance transactions expected to require restructuring in the coming years, lawyers and investors alike be warned!

SUPREME COURT INDICATES SUPPORT FOR SANCTITY OF CONTRACTUAL WATERFALL PROVISIONS BY DENYING LEAVE TO APPEAL FROM THE COURT OF APPEAL'S DECISION IN *PERPETUAL TRUSTEE COMPANY LIMITED V BNY CORPORATE TRUSTEE SERVICES LTD [2009] EWCA CIV 1160 ('PERPETUAL TRUSTEE')*

In contrast to Sigma, the Court of Appeal has affirmed the natural interpretation of a contract, in favour of broadening an established insolvency principle. The 'anti deprivation principle' is concerned to ensure that, upon a person's bankruptcy, his property must be applied for the benefit of his creditors and not others. For reasons which will be clear on reading the summary below, investors in the structured finance community can breathe a sigh of relief following this judgment and more importantly perhaps (following Sigma), the Supreme Court's recent denial of leave to appeal.

Perpetual Trustee was concerned with the validity of a waterfall provision in a security trust deed of a CDO. The waterfall provided that, in an enforcement scenario, the swap counterparty (being Lehman Brothers Special Financing Inc. ('LBSF')), would be paid the proceeds of enforcement of the CDO collateral, in priority to the CDO noteholders, unless an Event of Default in respect of LBSF had occurred under the swap agreement: in that event, the waterfall switched so as to provide that LBSF would be paid after the noteholders. The swap agreement provided that an Event of Default in respect of LBSF included LBSF or its parent's (being Lehman Brothers Holdings Inc. ('LBHI')) insolvency. During the course of the swap agreement, LBHI became 'insolvent' (by filing for Chapter 11 protection). Some time thereafter, LBSF itself also went into insolvency.

When the CDO itself defaulted, thereby triggering an enforcement of the CDO collateral, LBSF's liquidator argued that the switch in priority on the waterfall deprived the LBSF insolvent estate of funds which it would otherwise have received, in breach of the anti deprivation principle. The Court of Appeal disagreed, principally for the following reasons: (1) the anti deprivation principle only applies to arrangements taking effect at the date of insolvency *of the person whose estate is allegedly deprived of assets* – in this case, the alleged deprivation occurred prior to LBSF's insolvency (ie when LBHI's insolvency triggered the Event of Default under the swap agreement); and (2) LBSF's priority over noteholders was only a right which was contingent upon there being no Event of Default in respect of it under the swap. The Court regarded the effect of the change in priority as not divesting LBSF of an asset actually vested in it and of vesting them in the noteholders, but rather to 'change the order of priority in which the rights were to be exercised in relation to the proceeds of sale of the collateral in the event of a default'.

For the certainty it provides, this decision should be welcomed by the structured finance market.

FURTHER HOPE FOR SANCTITY OF CONTRACT: *CATTLES PLC V WELCOME FINANCIAL SERVICES LTD ('WELCOME') AND THE ROYAL BANK OF SCOTLAND PLC AND PARTY A [2009] EWHC 3027 (CH)*

This week, RBS filed a cross-appeal in the bondholders appeal against the judgment at first instance. An analysis of the issues at stake is of interest to the distressed investing community: as is well known in the market, the Cattles group has been undergoing financial distress for some time. All its debt has defaulted and it is in the process of endeavouring to restructure its debt.

Cattles plc is a holding company for a consumer financial services business and it relies on distributions from Welcome, its principal operating subsidiary, to pay its creditors. During the course of restructuring negotiations, disagreement as to the priority of payments has arisen amongst its two categories of creditors.

The debtor and creditor situation can be summarised as follows:

- The bondholders have an unsecured claim against Cattles only;

- The bank creditors, in addition to having an unsecured claim against Cattles, benefit from unsecured cross guarantees from the entire Cattles group. The guarantee includes a clause providing as follows:

  > until all claims of the Bank have been discharged in full, no Guarantor shall be entitled to *'make any claim in competition with or in priority to the Bank'* [cl.6]

  The term 'Guarantor' includes all group companies (including Cattles and Welcome Finance);

- If it performs on the guarantee, Welcome will have a claim *(subject to the terms of the guarantee)*, in subrogation against Cattles; and

- Cattles has a claim against Welcome for repayment of the loan which Cattles on-lent to Welcome. This loan comprises the proceeds of the bank debt and bond issue.

HHJ Cooke, sitting in Chancery, upheld the effectiveness of the guarantee, ruling that the bank debt should obtain priority over the bond debt. Thus, Cattles may not make a claim against Welcome until all the bank debt has been paid in full. This, of course, thwarts any claim that the bondholders have, since their claim relies on Cattles being put into funds by Welcome under the inter-company debt owed to Cattles.

Some detail: the judge disagreed with the bondholders' argument that, on a proper interpretation of the guarantee, it only prohibited claims which arise from Cattles in its capacity as guarantor under the guarantee of obligations of Welcome (and not claims by Cattles against Welcome for the inter-company debt). The judge disagreed, holding that the claims which are prohibited are *'any claim'* (including the inter-company debt), and stating that a claim is 'just as much in competition for the assets if it arose entirely separately from the guarantee arrangement'.

The Court came to this decision on the basis of a natural reading of the words in the guarantee as well as on the basis of the general commercial intention of such wording in a guarantee, stating: "the purpose of the clause is obviously to increase the Bank's realisations from the assets of any particular group company. It seeks to achieve this by restricting claims that might be made *'in competition with or in priority to the bank'.*"

This balance between a genuine attempt to construe the actual words used in the agreement and applying a purposive construction should be favourably viewed in the market.

Another point which arose in the course of argument, and which is only relevant if the judge is found on appeal to be wrong on the first point, was the rule in *Cherry v Boultbee*, which provides that a person cannot

take a share out of a fund without first bringing into account what he owes to the fund. The application of the rule to different situations can be of some debate amongst lawyers. In this case, the bank argued that it meant that, if Welcome were to go into administration, and Cattles were to prove in its estate for the inter-company debt owing to it, Welcome's administrator would be entitled to a 'right of quasi-retainer… against Cattles, by virtue of which it would treat any dividend otherwise due to Cattles in respect of its inter-company debt as being initially satisfied by Cattles' own liability to counter-indemnify Welcome against Welcome's liability to the Bank under the Guarantee'. The court agreed with this in principle. However, the bondholders argued that Welcome's right to exercise the quasi-retainer had been excluded by contract under the Guarantee. The judge agreed with the bondholders' argument, holding that a claim of quasi-retainer constitutes the making of a claim for the purposes of cl.6.2.

However, at the end of the judgment, the judge stated that he would be 'sympathetic to an application for permission to appeal… as the issues raised in this case are clearly capable of argument and of considerable importance to the parties and potentially to others'. The bondholders have appealed and, just this week, the bank cross appealed against the contractual exclusion point.

We understand that the appeal is to be any time from the spring to 4 October, 2010.

Cattles' investors and prospective investors, stay tuned! But in the meantime, the uncertainty of a looming appeal may lead to more difficulties for Cattles to achieve an agreement on the proposed restructuring, which is so necessary for its survival as a going concern – or perhaps the judge's sensible approach will strike a chord and incentivise decisive and swift action.

CHANGES TO LMA STANDARD FORMS FOR PAR AND DISTRESSED LOAN AND CLAIMS TRADES ENTERED INTO AS OF 25TH JANUARY, 2010

The new LMA forms for trading European loans and bank claims came into effect on 25th January. Any trade governed by LMA entered into on or after that date must be settled using the new documents.

Traders in this area should familiarise themselves with the details of the new documentation. The headline changes can be summed up as follows:

- There is now a single form of trade confirm and set of standard terms and conditions which apply for both par and distressed trades (including additional representations and warranties for par trades);

- An option to terminate the trade in the event of insolvency of one of the parties to the trade is now included, along the lines which have applied for years in ISDA. Following the exercise of the option, the non-insolvent party must obtain quotations for the asset and an early termination payment amount will be calculated to reimburse the potential loss either way; and

- A new buy-in/sell-out provision applies for par trades. This provides that a buy-in/sell-out notice may be served on the defaulting party after T + 60, following which, a detailed time line and steps leading to a third party buy-in or sell-out, will apply.

The format of the new trade confirm is such that less 'optionality' is provided for. This means that parties will be well advised to prepare a customised check list of all material points to be borne in mind at the time of a trade, and vigilantly bear in mind the special conditions that they wish to apply on a trade – and these will have to specifically be set out in the 'alternative/additional/trade specific terms' of the trade.

If you would like more detail on the changes, we are happy to provide a seminar for you. As one of Brown Rudnick's core practice areas, the Firm's Distressed Bank and Claims Trading Team works closely with the Bankruptcy and Restructuring Group. Within the last five years, Brown Rudnick has closed in excess of the equivalent of $30bn.

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