Contractual interpretation and penalties in the Financial List

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Hayfin Opal Luxco 3 SARL & Anor v Windermere VII CMBS plc & Ors

The Financial List has promptly disposed of a case regarding the construction of complex documents in a commercial mortgage-backed securitisation structure (CMBS). Snowden J adopted a strict approach to the construction and interpretation of highly negotiated documents, demonstrating that the Financial List will not refashion negotiated deals with the benefit of hindsight to assist the unwise.

The dispute concerned complex financial instruments in a CMBS transaction arranged by Lehman Brothers International (Europe). The CMBS structure included (i) "regular notes", which paid interest at a floating rate of 3 month EURIBOR, plus a margin, and (ii) "Class X" notes, which would pay the holder any excess interest which the issuer could expect to earn from the underlying commercial mortgage loans, over and above the amounts that the issuer was obliged to pay in respect of certain fees and costs associated with the CMBS structure and the amount of interest payable on the "regular notes".

Issues arose over the Class X notes. The claimants, Hayfin, brought declaratory proceedings and the parties' arguments essentially focussed on (i) the correct computation of payments to the holders of the Class X notes, and whether there was a mistake in the definition of Senior Rate and Junior Rate in the Intercreditor Agreement, and (ii) whether any unpaid Class X interest (which exceeded 5000% per quarter at certain periods) was a penalty and therefore void.

Interpretation of the Agreement

The claimants contended that the definitions in the agreement needed to be corrected by construction or by implying additional words into the agreement. Snowden J noted that whether the inclusion of the claimants' wording should be characterised as "the process of correcting a mistake by construction" (following the *Chartbrook Ltd v Permission Homes Ltd* line of authority) or as "the process of implying terms" (following the *Marks and Spencer plc v BNP Paribas* line of authority) may be open to debate but both lines of authority have the following common features:

- The court will not supply additional words or terms simply because it is reasonable to do so in the circumstances which have arisen.
- The court will only add words to the express terms of an agreement if it necessary to do so because the agreement is incomplete or commercially incoherent without them.
- Even then, the court must be certain both that the absence of the missing words was inadvertent, and that if the omission had been drawn to the attention of the parties at the time of contracting they would have agreed what additional provision should be made.

Following these principles, Snowden J held that the definitions of Senior Rate and Junior Rate were "not mere boilerplate, but carefully constructed and central to the commercial deal being struck between the contracting parties to the Intercreditor Agreement." Accordingly, he held that the absence of the proposed additional wording was not the result of an oversight or mistake and no additional wording was required. He concluded that there had been no underpayment of interest.

Penalty

Given Snowden J's conclusion that there had been no underpayment of interest, it was not strictly necessary for him to consider whether any unpaid interest attracted interest at the Class X interest rate and whether, as the first defendant contended, that payment would have been void as a penalty. Nevertheless, at the parties' request, he expressed his obiter view on the issue.

Snowden J proceeded on the basis that the penalty doctrine would apply. In doing so, he referred to the recent Supreme Court decision in *Cavendish Square Holding BV v El Makdessi*, which affirmed that the penalty clause doctrine only applies to contractual provisions that impose secondary obligations upon a party in the event of a breach of primary obligations under the contract, and noted that the parties did not dispute that the accrual and payment of interest at the Class X interest rate could be regarded as a secondary obligation imposed on a contract-breaker (a point he said he did not necessarily agree

with but a point upon which he had not heard any argument).

Proceeding on this basis, Snowden J said he was inclined to accept that the interest provision breached the penalty doctrine and added; "In any conventional terms, the imposition of such interest rates for breach in failing to make payment of a sum due would be regarded as exorbitant (if not extortionate)."

He made the following points (obiter):

- The fact that the obligations of the issuer are imposed on a limited recourse basis was irrelevant to the application of the penalty doctrine.
- The penalty doctrine is "objective" and focuses on "the lack of proportionality between the amount of the secondary liability imposed and the innocent party's legitimate interest in performance of the primary obligation." Accordingly, whether a clause is a penalty does not depend on the ability of the contract-breaker to pay the specified amount or the source from which he is to pay.

Comment

This decision helpfully shows how the Financial List is likely to approach disputes turning on the construction and interpretation of carefully negotiated, complex financial agreements, and reinforces that the courts will not be quick to add words or interfere with agreements in these circumstances.

Snowden J's obiter comments on penalties highlight the importance of the first limb of the new penalty test laid down by the Supreme Court in *Cavendish*: whether the contractual provisions impose a primary or secondary obligation on the contract breaker. The parties were in agreement that they imposed a secondary obligation (thus bringing the penalty doctrine into play), although Snowden J expressly made the point that he did not necessarily agree with this view and his conclusion that the interest provision was a penalty must be seen in this context.

Of course, Snowden J may have dealt with the penalty argument differently had the parties disputed the first limb of the penalty test and he had heard full arguments on this issue. We will have to wait and see whether the Financial List will give regard to his obiter comments on penalty provisions in another case involving highly negotiated financial agreements.

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