Neutral Citation Number: [2019] EWHC 778 (Ch)

Case No: FL-2018-000014

IN THE HIGH COURT OF JUSTICE
BUSINESS AND PROPERTY COURTS OF ENGLAND AND WALES
FINANCIAL LIST

The Rolls Building
The Royal Courts of Justice
7 Rolls Building, Fetter Lane,
London EC4A 1NL

Date: 28/03/2019

Before:

Sir Geoffrey Vos, Chancellor of the High Court

B E T W E E N

DEUTSCHE TRUSTEE COMPANY LIMITED

Claimant

and

(1) DUCHESS VI CLO B.V.
(2) BARINGS (U.K.) LIMITED
(3) NAPIER PARK EUROPEAN CREDIT OPPORTUNITIES FUND LIMITED

Defendants

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Mr Stephen Robins (instructed by **Allen & Overy LLP**) appeared for the **Claimant**

The **first Defendant** did not appear, but agreed to be bound by the final decision of the court

Mr Jeremy Goldring QC (instructed by **Dentons UK and Middle East LLP**) appeared for the **second Defendant**

Mr David Wolfson QC and Mr Andrew de Mestre QC (instructed by **Collyer Bristow LLP**) appeared for the **third Defendant**

Hearing dates: 12-13th March 2019

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Approved Judgment

I direct that pursuant to CPR PD 39A para 6.1 no official shorthand note shall be taken of this Judgment and that copies of this version as handed down may be treated as authentic.

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Sir Geoffrey Vos, the Chancellor of the High Court:

Introduction

1. Deutsche Trustee Company Limited is the claimant and the trustee (the "Trustee") of a European collateralised loan obligation securitisation transaction set up by a Trust Deed dated 17th August 2006 (the "Transaction"). That was, of course, before the global financial crisis began in 2008. The Trustee has brought these proceedings under CPR Part 8 in order to determine 5 questions of interpretation of the Transaction documentation. It joined two defendants into the proceedings, and Marcus Smith J joined the third on 29th October 2018.

2. The first defendant issuer, Duchess VI CLO B.V. (the "Issuer"), has decided to take no active part in the proceedings save to agree to be bound by the court's decision. The substantive argument is between the second defendant collateral manager, Barings (U.K.) Limited (the "Collateral Manager") on the one hand, and Napier Park Global Capital Limited ("Napier"), which holds Class F Secured Income Notes (the "Class F Notes") on the other hand. Napier represents the holders of all the Class F Notes (the "Class F Noteholders"). In broad terms, the Class F Notes were the only class of risky "equity" notes, whilst the senior debt comprised Class A, B, C, D and E floating rate "debt" notes (totalling a principal sum of some €322.5 million) payable by reference to 3-month EURIBOR plus a margin (the "senior Notes").[1] The senior Notes were investment grade, but the Class F Notes were not.

3. In the broadest of outline, the Collateral Manager claims to be entitled to some €15,303,430.73 (the "Monies") in respect of an Incentive Collateral Management Fee ("ICMF") that is alleged to have fallen due as a result of the Class F Noteholders (including Napier) voting on 10th January 2018, by more than two-thirds of their value, to redeem the Class F Notes on 1st February 2018 (which became the "Redemption Date" as defined by the Transaction documentation). Napier contends that, on the proper interpretation of the Transaction documentation, no ICMF falls due on such a redemption. The Monies representing the ICMF are held by the Trustee to abide the outcome of this hearing.

4. The issues posed by the Trustee and agreed by the parties are appended to this judgment as Annex A, but in short form they are as follows:-

    i) Issue A: Is the Collateral Manager entitled to an ICMF under clause 14.1 of the Collateral Management Agreement (the "CMA") when an option to redeem the Class F Notes under Condition 7(b)(i)(A) is exercised?

    ii) Issue B: If so, is the ICMF limited to that which is "accrued and unpaid" immediately prior to the Redemption Date?

    iii) Issue C: If so, in determining whether the Class F Secured Income Threshold (the "SIT") has been reached, should any principal payable to the Class F Noteholders on the Redemption Date be excluded from the calculation?

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[1] There are also intermediate Class J Notes, which do not affect the dispute that I have to determine.

iv) Issue D: If so, should the amounts constituting the Cumulative Subordinated Income ("CSI") in respect of the ICMF include the priority of payments set out in Condition 11(b) (even though that is not referred to in the definition of CSI), and deduct the amounts payable under Condition 11(b)(A)-(T) from the amounts distributed?

v) Issue E: If the ICMF payable in respect of the Redemption Date is limited by reference to the amounts distributed earlier to the Class F Noteholders, should an ICMF be calculated when further distributions are made to take into account distributions to the Class F Noteholders made in respect of the Redemption Date?

5. Before going any further, it is necessary to set out the two critical clauses that need to be interpreted.

6. First, clause 14.1 of the CMA (entered into on 17th August 2006 between the Issuer, the Collateral Manager, the Trustee (as Trustee and separately as Security Trustee), and Deutsche Bank AG, London Branch (the "Collateral Administrator")) ("clause 14.1") provided as follows:-

> "14.1 Fees
> The Collateral Manager shall be paid the following amounts on each Payment Date, subject to Condition 4(d) (*Limited Recourse*) of the Conditions and in accordance with the Priorities of Payment:
> (a) … the portion of the Base Collateral Management Fee which is payable on such Payment Date …; and
> (b) the Incentive Collateral Management Fee [ICMF]".

7. Secondly, the definition of ICMF (the "ICMF definition") in the "Terms and Conditions" in the Second Schedule to the Trust Deed and in the "Conditions of the Notes" (the "Conditions") attached to the Prospectus, was as follows:-

> "***Incentive Collateral Management Fee*** means the fee payable to the Collateral Manager on each Payment Date in accordance with paragraph (II) of Condition 3(c)(i) (*Application of Interest Proceeds on Payment Dates*) and paragraph (BB) of Condition 3(c)(ii) (*Application of Principal Proceeds on Payment Dates*) and pursuant to the Collateral Management Agreement, which in total is equal to 20 per cent. of the Cumulative Subordinated Income in excess of the principal amount of the Class F Secured Income Notes issued on the Closing Date provided that (after taking account of the interest to be paid to the Class F Secured Income Noteholders on that Payment Date) the Class F Secured Income Threshold shall have been reached".

8. Before describing the competing positions of the parties, it is necessary to explain four basic parameters of the Transaction as they affect the meaning of the ICMF.

9. First, the defined term "Payment Date" means "1 February, 1 May, 1 August, and 1 November of each year, commencing on 1 February 2007, the Maturity Date [1st August 2022] and any Redemption Date [each date specified for a redemption of the

Notes of a Class pursuant to Condition 7 (*Redemption*) or the date on which the Notes of such Class are accelerated pursuant to Condition 10 (*Events of Default*)]".

10. Secondly, the definition of "Priorities of Payment" explains that that term means the four payment waterfalls set out in Condition 3 "save in respect of any redemption of the Notes pursuant to Condition 7(b) (*Optional Redemption*) and prior to enforcement of the security over the Collateral in accordance with Condition 11 (*Enforcement*)". In the event of *Optional Redemption* or *Enforcement*, the payment waterfall in Condition 11 is to apply. I will come in due course to the significant differences between the Condition 3 waterfalls and the Condition 11 waterfall. For present purposes it suffices to know that, whilst there are differences, there are also similarities. One of the similarities is that in the two main interest and principal waterfalls in Condition 3 and in the single Condition 11 waterfall, the ICMF is always referred to as the "accrued and unpaid [ICMF]" (Conditions 3(c)(i)(II), 3(c)(ii)(BB), and 11(b)(U)).

11. The third and fourth parameters concern the hurdles that must be surmounted in order for an ICMF to become payable.

12. The first hurdle (the third parameter) is that the CSI must be in excess of the principal amount of the Class F notes (which was €52.5 million). The CSI is defined (in broad terms) as the sum of four aggregate cumulative interest and principal proceeds available for the Class F Notes by reference only to the Condition 3(c) waterfalls (together with cumulative sale proceeds). The definition of CSI does not refer to the Condition 11 waterfall. Significantly, four of the five types of proceeds enumerated in the CSI definition specifically exclude the paragraphs of the Condition 3 waterfalls that provide for payments to the senior Notes, and the fifth relating to cumulative sale proceeds does not refer to any waterfall.

13. The second hurdle to the payment of an ICMF (the fourth parameter) is that, after taking account of the interest to be paid to the Class F Noteholders on that Payment Date, the SIT must have been reached. The SIT is defined as "the threshold which would have been reached on the relevant Payment Date if the [Class F Noteholders] have received an internal rate of return ("IRR") of at least 10 per cent. per annum … calculated on the basis of aggregate distributions to the [Class F Notes]". Thus, an ICMF only gets paid, in simple terms, if the aggregate principal and interest return to the Class F Noteholders exceeds the original principal of €52.5 million, and the aggregate IRR exceeds 10% per annum.

14. Against this basic background, the Collateral Manager argues that clause 14.1 is clear. It provides that an ICMF "shall be paid … on each Payment Date … and in accordance with the Priorities of Payment". The definition of "Payment Date" includes "Redemption Date" on an *Optional Redemption* as occurred here. The definition of "Priorities of Payment" expressly applies the Condition 11 waterfall to an *Optional Redemption* pursuant to Condition 7(b). The reference in Condition 11(b)(U) in the Condition 11 waterfall to the distribution of "accrued and unpaid [ICMF]" must refer to ICMF accrued on the Redemption Date, not only to previously accrued ICMF, since it must mean the same in all the waterfalls. The Collateral Manager contends that the commercial context is critical. It would be absurd if an ICMF were payable on every payment date except on *Enforcement* or *Optional Redemption*. There is no commercial rationale for such an outcome and the wording

does not require it. It would enable the Class F Noteholders to avoid payment of an ICMF wholly unjustifiably.

15. Napier submits in response that there are three main reasons why an ICMF is not payable on an *Optional Redemption*: the language of the Transaction documentation, the way in which a Condition 7 *Optional Redemption* works, and the commercial circumstances of the Class F investment.

i) As regards the language, Clause 14.1 simply engages the ICMF definition. The ICMF definition defines an ICMF as the "fee payable on each Payment Date in accordance with [the Condition 3 waterfalls]". It does not mention any fee payable where the Condition 11 waterfall applies. That is reinforced by the definition of CSI, which is also referred to in the ICMF definition. The CSI is the aggregate cumulative interest and principal proceeds available for the Class F Notes **after** taking account of all sums due to the holders of the senior Notes (the "senior Noteholders"). It cannot apply to a Condition 11 distribution, because, if it did, there would be no equivalent deduction of the sums due to the senior Noteholders and others (which are set out in Condition 11(b)(A)-(T)). The CSI would accordingly be calculated on all distributions including those to senior Noteholders. The references to "accrued and unpaid [ICMF]" in the waterfalls do not tell you when it was accrued. It cannot accrue under the Condition 11 waterfall because of the ICMF definition, which refers only to the Condition 3 waterfalls.

ii) An *Optional Redemption* under Condition 7 cannot work if ICMF is paid out under the Condition 11 waterfall for two reasons. First, Condition 7(b)(ii) requires the Collateral Administrator to calculate the "Redemption Threshold Amount" 14 days before the Redemption Date, because there can be no *Optional Redemption* unless 5 days before the scheduled Redemption Date, the Collateral Manager has provided the Trustee with evidence that it has a binding agreement with a rated financial institution to sell Collateral Debt Securities in sufficient amounts to raise that Redemption Threshold Amount in cash. In other words, there must be cash available at the Redemption Date to pay off the senior Noteholders **and** the ICMF, if the Class F Noteholders are to be allowed their *Optional Redemption.* Napier's point is not only that there is no evidence that this was done in this case, but, more importantly, it could not have been done without calculating the ICMF before the Redemption Date which was not itself possible if a further amount of ICMF fell due on the Redemption Date. Secondly, Napier draws attention to the difference between the priorities in the Condition 3 waterfalls and the Condition 11 waterfall. The Condition 3 waterfalls pay interest up to the SIT to the Class F noteholders in priority to the ICMF, whilst the Condition 11 waterfall pays the Class F Noteholders nothing before payment of the ICMF. Here, the Collateral Manager says that an ICMF is due because the SIT is reached as a result of the payments of interest and principal due on redemption. The IRR was only at 7.54% before the Redemption Date, and exceeded 10% only when the redemption payments were taken into account. Since the Condition 11 waterfall pays the ICMF **before** the Class F Noteholders get anything, the SIT cannot be reached when the ICMF is calculated and paid under Condition 11(b)(U). These points demonstrate, according to Napier, that it was always

intended that there should be no new ICMF payable on the running of the Condition 11 waterfall.

iii) Finally, Napier submits that the whole commercial substratum of the Transaction was for the Class F Noteholders to make a risky investment and to recover an ongoing IRR greater than 10%. Had the financial crisis not occurred, that is what would probably have happened, and ICMF would have been payable every Payment Date from the 5th year (or thereabouts) of the Transaction when the CSI would have exceeded the Class F principal amount. It was only because of the financial crisis and the consequent need to use income to pay the senior Noteholders for some years that the SIT was not reached before the *Optional Redemption* occurred. It was never intended that ICMF would be paid on *Enforcement* or *Optional Redemption*. The ICMF was an ongoing incentive payment intended to reflect the achievement of the performance target of an IRR exceeding 10% over the life of the Class F Notes.

16. I will return to an evaluation of these arguments in due course.

Factual background

17. The portfolio of investments represented by the Transaction consisted of approximately 100 borrowers across a range of financial assets denominated in sterling and euros in different geographical areas and industries, including senior secured loans, second lien loans, mezzanine loans and high yield bonds.

18. The Collateral Manager was appointed by the Issuer under the CMA. It is agreed that the Collateral Manager was appointed to select which financial assets were to be acquired, and generally to manage the portfolio; it was responsible for analysing and investing in new opportunities, and for the ongoing monitoring of the performance of investments. Performance of the Notes depended on the skill of the collateral manager in analysing, selecting and managing the underlying investments.

19. As has already been noted, Clause 14 of the CMA provided for two fees for the Collateral Manager. First, a Base Collateral Management Fee, which was payable at 0.70% of assets per annum quarterly in arrears and was subordinated to all interest on the senior Notes. It was agreed that the purpose of the Base Collateral Management Fee was to compensate the Collateral Manager for its day-to-day management of the portfolio. Secondly, the ICMF of 20% of the CSI was payable once the SIT was reached.

20. Condition 3(c) of the Conditions set out the Priorities of Payment for pre-enforcement payment dates "save for any Redemption Date applicable to the redemption of the Notes pursuant to Condition 7(b)". Condition 3(c)(i) dealt with the application of "Interest Proceeds", and Condition 3(c)(ii) dealt with the application of "Principal Proceeds". Condition 11 set out the Priorities of Payment applicable to redemption of the Class F Notes under Condition 7(b). Paragraphs (U) to (W) of Condition 11(b) subordinated redemption of, and interest distributions in respect of, the Class F Notes to payment of "accrued and unpaid [ICMF]".

21. It was open to the Class F Noteholders to exercise an option to ask the Issuer to redeem the Notes, liquidate the portfolio and distribute pursuant to the Condition 11 Priorities of Payment, on any Payment Date after 17th August 2011. They in fact did so, as I have said, to take effect on 1st February 2018, and the Portfolio was liquidated by the Collateral Manager under Condition 11 so that approximately €102 million of sale receipts were received on or before that date. The Collateral Manager claimed an ICMF under paragraph (U) of Condition 11(b) as at that date in the sum of €12,124,252.73. That sum was placed in escrow and the balance of €21,305,098.17 was paid to the Class F Noteholders under paragraph (V) of Condition 11(b). Thereafter, a further €15,895,890.00 was received, from which the Collateral Manager claimed €3,179,178.00 by way of ICMF, making a total ICMF of €15,303,430.73 (the Monies), subject to costs and exchange rates.

The relevant evidence

22. I shall not attempt to set out the witness statements produced by the parties in full. I should say, however, that they provide a good example of how witness statements should be used. They set out, concisely, factual background and eschew argument or tendentiousness.

23. Mr Olufemi Oye of the Trustee set out in his witness statement the competing positions of the Collateral Manager and Napier as had been described in correspondence and as were to be developed subsequently in their respective position papers.

24. Mr Robert Faulkner of the Collateral Manager described an ICMF as follows in his witness statement at paragraph 8(g):-

> "The [ICMF] is a share of the profit made by the [collateralised loan obligation] after making payments due on the "debt" notes and only payable to the collateral manager after a defined level of profit in the transaction has been obtained by the "equity" notes. The [ICMF] incentivises the collateral manager to manage the portfolio so that it optimises returns on the portfolio for the benefit of the subordinated or "equity" notes".

25. It was common ground that the returns payable to Class F Noteholders would depend, to a significant extent, on the skills of the Collateral Manager.

26. Mr Michael Micko of Napier explained the risky nature of the Class F Notes and why they performed as they did as follows:-

> "11. … the Class F Notes are the riskiest of the various Notes and effectively form the equity tranche of the debt issued by the [Issuer]. The F Notes reflect an approximately 10x leveraged position on a portfolio of loans each of which was rated as below investment grade. The expectation in the market (which [Napier] shared) when the [Issuer] issued the Notes was that, because of the structure of the Transaction and the nature of the assets to be included within the [Issuer's] portfolio, the Class F Noteholders would receive the majority of the funds payable to them by way of interest over the life of the Transaction rather than by way of principal repayment when the Notes were redeemed. Indeed, it was expected that the 10% IRR

threshold for the Class F Noteholders would be reached earlier in the life of the deal through payments made in the quarterly application of the interest proceeds waterfall.

12. In fact, in this case, the 10% IRR threshold was not reached through the regular quarterly payments and, by the time the Class F Noteholders exercised their contractual right to call for the redemption of the Notes in January 2018, the IRR was only 7.58%. This equates to the Class F Noteholders being some €16 million short of the total sum received necessary to amount to an IRR of 10%.

13. The principal reason why the l0% IRR threshold was not reached during the life of the deal was that between February 2009 and February 2014 some or all of the amounts which would ordinarily have been paid to the Class F Noteholders was diverted to the repayment of principal of the Class A Notes or the purchase of additional portfolio securities. This happened because the deal failed various of the Coverage Tests contained in the [Conditions].

…

31. … the return to the Class F Noteholders was still well short of 10% after nearly 12 years of the Transaction when they chose to call for an early redemption – Mr Faulkner's complaint is really that the Class F Noteholders have a contractual right which they can exercise at a time when the Collateral Manager would prefer the deal to continue, because the Collateral Manager might be able to earn an [ICMF] if the deal continues but will not be able to earn that Fee if the deal is brought to an end. This right is however, an integral part of the [Conditions] and there are no restrictions on when the right can be exercised. Moreover, I do not understand it to be said that the Class F Noteholders are obliged to have regard to the interests of [the Collateral Manager] (as opposed to their own commercial interests) when exercising their right.

32. Further, it appears to me that a similar point might be made on [the Collateral manager's] interpretation under which the Class F Noteholders would be able to monitor their returns and call for an early redemption where, even taking into account the amount of principal that they would receive on that final date, no [ICMF] would be payable. This decision might be made at a time when the Collateral Manager was hoping for the deal to continue in order that the IRR obtained by the Class F Noteholders might exceed the 10% threshold. The fact that a decision made by the Class F Noteholders might mean that no [ICMF] is payable is the result of the [Conditions] providing for different results depending on whether the IRR threshold of 10% has been reached at particular points.

33. Equally, if the deal is performing well and the 10% IRR threshold is reached early (for example as was anticipated here), then the Class F Noteholder is very likely to be happy to allow the deal to run anticipating further returns even if an [ICMF] is also payable. This can be seen from [Exhibits MM1/2] which show what would have happened here if the

> excess interest income had not been diverted but had been paid to the Class F Noteholders and to [the Collateral Manager] as [an ICMF]. In this case, after an IRR of 10% is reached in August 2013, thereafter over the course of the regular quarterly distributions, the Class F Noteholders would have received further distributions totalling €36.6 million even after some €13 million had been paid by way of [ICMF] to the Collateral Manager".

27. Mr Faulkner responded to this evidence in his second witness statement as follows:-

> "11. At paragraph 11 of his statement, Mr Micko suggests that the "*expectation in the market (which Napier Park shared)*" when the [Issuer] issued the Notes was that the [Class F Noteholders] would receive the majority of the funds payable to them by way of interest rather than by way of principal repayment on redemption.
>
> 12. I was not involved in the transaction at the issue date (nor indeed was [Napier]), and Mr Micko does not confirm the source of this statement. However, in my experience, at the outset of a transaction such as this one a range of different possibilities is contemplated by the transaction parties, one always being that a significant return to "equity" investors may be of principal. This is naturally dependent on the assets and their ultimate performance, as well as prevailing market conditions, which over the course of a long transaction can fluctuate significantly. In any event, the market expectation at the time of the transaction is unlikely to have factored in the global financial crisis that followed, and the effect that would have on asset performance and resulting cash flows".

<u>The applicable law on interpretation of contracts</u>

28. I shall not recite in detail the current approach to the interpretation of contracts, which is extremely well known. That approach can be taken most accessibly from the Supreme Court's recent decisions in *Rainy Sky v. Kookmin Bank* [2011] 1 W.L.R. 2900 ("*Rainy Sky*"), *Arnold v. Britton* [2015] A.C. 1619 ("*Arnold*") and *Wood v. Capita Insurance Services Limited* [2017] 2 WLR 1095 ("*Wood*").

29. The parties referred specifically to what Lord Neuberger had said at paragraphs 15 and 19 of *Arnold* in relation to the interpretation of a lease as follows:-

> "15. When interpreting a written contract, the court is concerned to identify the intention of the parties by reference to "what a reasonable person having all the background knowledge which would have been available to the parties would have understood them to be using the language in the contract to mean", to quote Lord Hoffmann [at paragraph 14 in *Chartbrook Ltd v. Persimmon Homes Ltd* [2009] 1 A.C. 1101]. And it does so by focussing on the meaning of the relevant words … in their documentary, factual and commercial context. That meaning has to be assessed in the light of (i) the natural and ordinary meaning of the clause, (ii) any other relevant provisions of the lease, (iii) the overall purpose of the clause and the lease, (iv) the facts and circumstances known or assumed by the parties at the time that the document was executed, and (v) commercial common sense, but (vi) disregarding subjective evidence of any party's intentions.

> 19. The third point I should mention is that commercial common sense is not to be invoked retrospectively. The mere fact that a contractual arrangement, if interpreted according to its natural language, has worked out badly, or even disastrously, for one of the parties is not a reason for departing from the natural language. Commercial common sense is only relevant to the extent of how matters would or could have been perceived by the parties, or by reasonable people in the position of the parties, as at the date that the contract was made. …
>
> 20. Fourthly, while commercial common sense is a very important factor to take into account when interpreting a contract, a court should be very slow to reject the natural meaning of a provision as correct simply because it appears to be a very imprudent term for one of the parties to have agreed, even ignoring the benefit of wisdom of hindsight. The purpose of interpretation is to identify what the parties have agreed, not what the court thinks that they should have agreed. … Accordingly, when interpreting a contract a judge should avoid re-writing it in an attempt to assist an unwise party or to penalise an astute party.

30. Both parties also referred to the iterative process that should be engaged when interpreting documentation relating to collateral loan obligations and the like. That process involves checking each of the rival meanings against other provisions of the document and investigating its commercial consequences (see *Re Sigma Finance Corp* [2010] 1 All ER 571 ("*Sigma*") per Lord Mance at paragraph 12 and Lord Collins at paragraph 37, and *Rainy Sky* per Lord Clarke at paragraph 28).

31. Finally, I should mention what Lord Collins said at paragraph 37 of *Sigma* to the effect that the words used have a particular, even paramount, importance when the court is considering a traded instrument which will exist for a long time and pass through many hands. In such a case, Lord Collins thought that the matrix of fact ought only to be relevant in the most generalised way: "[t]he instrument must be interpreted as a whole in the light of the commercial intention which may be inferred from the face of the instrument and from the nature of the debtor's business". (See also *Hayfin Opal Luxco 3 SARL v. Windermere VII CMBS plc* [2016] EWHC 782 (Ch) at paragraphs 39-40 and 62 per Snowden J, and *Napier Park European Credit Opportunities Fund Limited v. Harbourmaster Pro-Rata CLO 2 BV* [2014] EWCA Civ 984, at paragraphs 31-2).

32. I turn, with that introduction, to consider the issues that have been placed before the court.

<u>Issue A, B and C</u>

33. In my view, these issues are best considered together, since they are intimately inter-connected. I have already summarised the main submissions of each of the parties. The central question is really quite a short one, namely was the Collateral Manager entitled to an ICMF under clause 14.1 of the CMA when the Class F Noteholders exercised their rights to an *Optional Redemption*. Issues B and C simply identify aspects of the arguments that have been deployed in support of one side or the other.

34. The starting point is, as always in contractual interpretation, an objective understanding of the language that the parties have used in its appropriate context. As the cases I have cited make clear, this aspect of the process is even more important where the rights created by an issue of this kind are likely to be traded to successive third parties over the life of the instrument.

35. In my judgment, the approach of the draftsman in this case seems to me to have been consistent and intelligible. It is only if one starts from the end of the process with the assumption as to what the words mean that any difficulty is encountered.

36. The key provisions are, as I have already said, clause 14.1 and the definition of ICMF. Clause 14.1 explains what the Collateral Manager is to be paid and when. The crucial words apply, significantly I think, to **both** the Base Collateral Management Fee and the ICMF. They say that "[t]he Collateral Manager shall be paid the [proportion of the Base Collateral Management Fee payable, and the ICMF] on each Payment Date, … and in accordance with the Priorities of Payment". The last words referring to the "Priorities of Payment" are there simply, I think, in order to explain when and in which order the payments will be made. The clause 14.1 provision is quite general, and cannot be used to show one way or another when each waterfall will run and for what purpose. The reference to "Payment Date" applies the provision to all "Payment Dates", as defined, but like the reference to "in accordance with the Priorities of Payments" does not actually indicate that an ICMF will be payable on any particular Payment Date, only that it could be. In other words, clause 14.1 provides that payments of the two types of fee due to the Collateral Manager will be paid, if due according to the detailed Conditions, on each Payment date and in accordance with the payment waterfalls. That much seems to me to be relatively straightforward.

37. Moving to the definitions of the "ICMF" and "Base Collateral Management Fee", one gets further details of the amount of those fees and when they are to be paid. The definition of Base Collateral Management Fee provides that it is "the fee payable to the Collateral Manager on each Payment Date pursuant to the [CMA], equal to 0.70 per cent. per annum …". The ICMF definition provides that it is "the fee payable to the Collateral Manager on each Payment Date in accordance with paragraph (II) of Condition 3(c)(i) (*Application of Interest Proceeds on Payment Dates*) and paragraph (BB) of Condition 3(c)(ii) (*Application of Principal Proceeds on Payment Dates*) and pursuant to the Collateral Management Agreement, which in total is equal to 20 per cent. of the [CSI in excess of the €52.5 million] provided that (after taking account of the interest to be paid to the [Class F Noteholders] on that Payment Date) the [SIT] shall have been reached".

38. Ignoring the two threshold requirements in the ICMF definition for a moment, it is notable that the difference between the definitions of Base Collateral Management Fee and ICMF is that only the ICMF is said to be payable "on each Payment Date in accordance with [the Conditions 3(c)(i) and 3(c)(ii) waterfalls **and** pursuant to the CMA]". The Base Collateral Management Fee is payable "on each Payment Date pursuant to the [CMA]". Some meaning must, I think, be attributed to the different approaches adopted by the draftsman.

39. The Collateral Manager argues that the facts that (a) "Payment Date" includes a Redemption Date, and (b) that "Priorities of Payment" include reference to the Condition 11 waterfall is sufficient to show that the ICMF is payable in accordance

with the Condition 11 waterfall on a Redemption Date as much as on any other Payment Date in accordance with the Condition 3(c)(i) and 3(c)(ii) waterfalls. In my judgment, however, the definition of ICMF is at least a clear pointer against that interpretation.

40. It is then necessary to consider the thresholds in the ICMF definition to see whether they provide any indication as to when an ICMF can be paid.

41. The first threshold is that the ICMF is only paid when CSI exceeds the €52.5 million Class F Notes principal amount. The CSI refers to four aggregate cumulative interest and principal proceeds available for the Class F Noteholders by reference only to the Condition 3(c) waterfalls, and to "all cumulative sale proceeds from Collateral Enhancement Securities and Equity Securities" without reference to the Condition 11 waterfall. Moreover, Napier was right to submit that the definition of the CSI does not seem to envisage it needing to be calculated on an *Optional Redemption* because it does not refer to the deduction of payments that would be made to senior Noteholders under the Condition 11 waterfall (in Condition 11(b)(A)-(T)). If the CSI were calculated without deducting the payments due to senior Noteholders under Condition 11(b)(A)-(T), it would not provide a meaningful threshold for the ICMF at all.

42. The second threshold in the ICMF definition is the SIT, which is the "threshold which would have been reached on the relevant Payment Date if the [Class F Noteholders] have received an [IRR] of at least 10 per cent. per annum … calculated on the basis of aggregate distributions to the [Class F Notes]". There is, however, a qualification in the ICMF definition, namely that the SIT must have been reached "after taking account of the interest to be paid to the [Class F Noteholders] on that Payment Date". The Collateral Manager submitted that the word "interest" must be read as meaning "distribution". I do not see why that level of imprecision must be read into the drafting. The ICMF definition works perfectly well with "interest". It is a calculation that is made under the Condition 3 interest waterfall, which allows certain pre-SIT interest to be paid to Class F Noteholders under Condition 3(c)(i)(GG) before the ICMF, and the remaining interest and capital afterwards. The qualification simply provides that only the interest payable to Class F Noteholders due on the Payment Date in question is to be taken into account in calculating whether the SIT has been reached. The Condition 11 waterfall has no similar division, providing only that the ICMF is paid before all capital and interest is paid to Class F Noteholders under Condition 11(b)(V) and (W). As Napier pointed out, it is hard to see how the ICMF definition can work properly on an *Optional Redemption* payment date if it is to be taken to apply to the running of the Condition 11 waterfall. Under that waterfall, the ICMF has to be paid before the capital and interest due to Class F Noteholders, and that would not work if the SIT were only reached as a result of terminal interest and capital distributions due after the ICMF was paid.

43. There is also some validity in Napier's submission that Condition 7(b)(ii) requires the Collateral Administrator to calculate the Redemption Threshold Amount **before** the Redemption Date, knowing the final amount of the ICMF, in order to allow the Collateral Manager to provide the Trustee with evidence that it has agreed to raise sufficient cash to pay the Redemption Threshold Amount, which includes the ICMF. It is true that Condition 7(b)(ii) requires the amount of the ICMF to be calculated,

since the Redemption Threshold Amount is defined in Condition 7(b)(ii) as "the aggregate of the amounts which would be due and payable on redemption of the Notes on the scheduled Redemption Date and all other amounts which, pursuant to Condition 11 … rank in priority to the [Class F Notes]". That includes all the paragraphs of the Condition 11 waterfall including Condition 11(b)(U) (which is the accrued and unpaid ICMF), only excluding the payments to the Class F Noteholders in Condition 11(b)((V) and (W). In my judgment, the point is supportive of Napier's argument without being conclusive, since some estimate could presumably be made of the ICMF that would become payable if the Collateral Manager were right.

44. I turn then to deal with the arguments on both sides that the reference to "accrued and unpaid [ICMF]" in the waterfalls supports one interpretation or the other. In my judgment, it does not. Plainly the wording might reasonably be taken to mean the same wherever it appears. It may be noted, however, that that is not a universal rule as Lord Hoffmann pointed out in *Oxfordshire County Council v. Oxford City Council* [2006] UKHL 25, where at paragraph 27 he construed the word "locality" used twice in the same sub-section as meaning "a single locality" when first used and "locality or localities" when used for the second time.

45. The word "accrued" will generally mean in this context coming "into existence as an enforceable claim or right" (Oxford English Dictionary), though it can mean "made provision for at the end of a financial period" (Google). In the waterfalls, it seems to me that "accrued" simply signifies that the ICMF has become due. That does not tell the reader whether the ICMF in question has become due as a result of the running of the waterfall in question or at an earlier stage. To determine that question requires consideration of (primarily) clause 14.1 and the ICMF definition.

46. Drawing these threads of interpretation together, it seems to me that the Transaction documentation read as a whole is unambiguous. It points you to the definitions of Base Collateral Management Fee and ICMF to see when and how much is to be paid. The ICMF definition tells the reader in no uncertain terms that it is the fee payable to the Collateral Manager on each Payment Date in accordance with the Conditions 3(c)(i) and 3(c)(ii) waterfalls and pursuant to the CMA. For the reasons I have given, I do not think the reference to the Condition 3 waterfalls can be ignored. Had the draftsman intended that a new ICMF would accrue when the Condition 11 waterfall was run, there would have been a reference to the Condition 11 waterfall in the ICMF definition. A reference to the Condition 11 waterfall cannot be constructed as the Collateral Manager sought to do by reference back to Clause 14.1 and the meaning of "Priorities of Payment", when Condition 3 waterfalls are expressly referred to in the ICMF definition and the Condition 11 waterfall is not. Moreover, I do not think that much additional insight is gained by considering the circumstances in which an ICMF might accrue and become due, but be unpaid, on a particular Payment Date. Clause 14.1 plainly makes provision for such an eventuality, as does Condition 3(d) (which refers specifically to the "non-payment of any amounts referred to in [Conditions 3(c)(i) or 3(c)(ii)]"). The key point remains that the ICMF definition refers expressly to "the fee payable to the Collateral Manager on each Payment Date in accordance with paragraph (II) of Condition 3(c)(i) … and paragraph (BB) of Condition 3(c)(ii) … and pursuant to the [CMA]". If a new ICMF payment were to be calculated when the Condition 11 waterfall was applicable, under Condition

11(b)(U), such a payment could not be properly called a "fee payable to the Collateral Manager on [the Redemption Date] in accordance with paragraph (II) of Condition 3(c)(i) … and paragraph (BB) of Condition 3(c)(ii) … and pursuant to the [CMA]". It would only be a fee payable to the Collateral Manager on the Redemption Date in accordance with paragraph (U) of Condition 11(b) and pursuant to the [CMA]. Condition 11(b)(U) is simply not mentioned in the ICMF definition. The Collateral Manager's ingenious attempts to feed it in by cross-references do not, in my judgment, work. This interpretation is given further support, for the reasons I have given, by the definition of CSI, the way in which the SIT is to be applied, and by the need to calculate a Redemption Threshold Amount including the ICMF.

47. It remains only to consider whether the commercial background and the relevant factual matrix known to all parties at the date of the Transaction points towards a different interpretation. In this case, I have not found much assistance from the evidence of this background. I can quite understand both sides of the debate. The Collateral Manager might reasonably have expected an ICMF to be payable when there was a significant return of principal to equity investors. Conversely, putative or actual Class F Noteholders might reasonably contemplate that an IRR of 10% would be reached and ICMF would be payable quarterly after August 2013 (5 years into the Transaction). Neither of these expectations is inconsistent with the interpretation that I have concluded is the clear meaning of the words used. The return of principal to investors was part of the ongoing management of the investments at least after the end of the Reinvestment Period on 1st August 2013.

48. I can also understand that opinions may differ about the supposedly perverse incentive that is provided if Condition 7 *Optional Redemption* cuts off the right to payment of ICMF as a result of capital distributions. As it seems to me, however, the one unexpected event that occurred during the life of this Transaction was the financial crisis. I do not find it surprising that an issue that failed to pay equity Noteholders anything significant by way of interest or capital for 2 years between May 2009 and May 2011 may have been regarded as not having performed well. The expected IRR was 10% and that was not reached at any stage before the *Optional Redemption*. I cannot see how it can be said to be unjust or unexpected that the Collateral Manager should not be rewarded when it has failed to reach its SIT some 11½ years after the issue date. *Optional Redemption* was only possible after August 2011, but as Mr Micko explained in his evidence, if the issue was performing well, it would be in the interests of the Class F Noteholders to stick with it and pay the ICMF from quarter to quarter, rather than forcing a redemption just in order to deprive the Collateral Manager of ICMF.

49. These arguments do not, in my judgment, take the matter much further. This is a case where the language of the Transaction documents is clear in the context of the transaction, applying the iterative approach recommended in *Sigma* and in *Rainy Sky*. Commercial parties buying into such traded instruments expect to be bound by the language of them. They are entitled to the certainty and predictability that the adoption of a proper contextual interpretation of the language produces.

50. My conclusion on issues A, B, and C is that the Collateral Manager is not entitled to an ICMF under clause 14.1 of the CMA when an option to redeem the Class F Notes under Condition 7(b)(i)(A) is exercised. The ICMF definition does not refer to an

ICMF being payable in accordance with the Condition 11 waterfall. Issue B does not require determination, but the words "accrued and unpaid [ICMF]" in the Conditions 3 and 11 waterfalls refer to unpaid ICMF that is due under clause 14.1 and the ICMF definition. Issue C also does not require decision, but, in determining whether the SIT has been reached, aggregate distributions to Class F Noteholders are to be calculated including interest (but not capital) payable on the Payment Date in question, as provided for by the words in brackets at the end of the ICMF definition.

Issue D

51. The parties are agreed that, on the facts of this case, Issue D does not arise. As my reasoning above makes clear, had Issue D required decision, I would have held that the CSI does not require to be calculated on an *Optional Redemption* under Condition 7 and on the running of the Condition 11 waterfall, because no ICMF is payable on that event.

Issue E

52. This issue asks whether, if the ICMF payable in respect of the Redemption Date is limited by reference to the amounts distributed earlier to the Class F Notes, whether an ICMF be calculated when further distributions are made after the Redemption Date, to take into account distributions to the Class F Noteholders made in respect of the Redemption Date. In colloquial terms, the parties have asked whether the Condition 11 waterfall can run twice so as to provide for the payment of a further ICMF after the Redemption Date. The answer to this question is obviously "No". There can only be one Redemption Date, and no additional ICMF can be due or payable, unless it fell due on a Payment Date before the Redemption Date. Conditions 7(b)(i)-(iii) make it clear that an *Optional Redemption* is a one-off event. The fact that calculations may have to be adjusted afterwards as the final proceeds are got in can make no difference to that conclusion.

Conclusions

53. For the reasons I have given, the issues raised by the parties should be answered as I have indicated. The Class F Noteholders will, therefore, be entitled to the Monies. I would be grateful if counsel could draft an appropriate form of order to reflect the terms of this judgment.

Annex A

The agreed issues

Issue A: Whether, on the proper construction of Clause 14.1 of the Collateral Management Agreement, the Collateral Manager is entitled to the Incentive Collateral Management Fee (as defined in Condition 1) in the event that the option to redeem the Notes under Condition 7(b)(i)(A) is exercised.

Issue B: If the Collateral Manager is entitled to the Incentive Collateral Management Fee upon exercise of the option under Condition 7(b)(i)(A) whether on the proper construction of Condition 11(b): (i) the Incentive Collateral Management Fee payable is to be calculated by reference to amounts to be distributed on the Redemption Date (as defined in Condition 1); or (ii) the Incentive Collateral Management Fee payable is limited to that which is accrued and unpaid immediately prior to the Redemption Date.

Issue C: If the Collateral Manager is entitled to the Incentive Collateral Management Fee upon exercise of the option under Condition 7(b)(i)(A) whether, on the proper construction of the relevant Conditions, the determination of whether the Class F Secured Income Threshold (as defined in Condition 1) has been reached excludes any principal payable to the Class F Secured Income Noteholders (as defined in Condition 1) on the Redemption Date.

Issue D: If the Collateral Manager is entitled to the Incentive Collateral Management Fee upon exercise of the option under Condition 7(b)(i)(A) whether the determination of the amounts constituting the Cumulative Subordinated Income (as defined in Condition 1) in respect of the Incentive Collateral Management Fee should be made: (i) including by reference to the priority of payments set out in Condition 11(b) notwithstanding the absence of an express reference to Condition 11(b) in the definition of Cumulative Subordinated Income; and (ii) assuming [Issue D(i)] above is answered in the affirmative, by deducting the amounts payable under Condition 11(b)(A)-(T) from the amounts to be distributed on the Redemption Date.

Issue E: If the Collateral Manager is entitled to the Incentive Collateral Management Fee upon exercise of the option under Condition 7(b)(i)(A), but the fee payable in respect of the Redemption Date is limited by reference to the amounts distributed to the Class F Secured Income Notes immediately prior to that date, is the calculation of the Incentive Collateral Management Fee on any subsequent date on which further distributions are made to take into account distributions to the Class F Secured Income Noteholders made in respect of the Redemption Date?