Neutral Citation Number: [2016] EWHC 782 (Ch)

Case No: FL-2015-0006

IN THE HIGH COURT OF JUSTICE
CHANCERY DIVISION
FINANCIAL LIST

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

Date: 8 April 2016

Before :

MR JUSTICE SNOWDEN

- -

Between :

(1) HAYFIN OPAL LUXCO 3 S.A.R.L. **(2) HAYFIN TOPAZ 3 S.C.A.**	**Claimants**
- and -	
(1) WINDERMERE VII CMBS plc **(2) U.S. BANK TRUSTEES LIMITED** **(3) ELAVON FINANCIAL SERVICES LIMITED**	**Defendants**

- -

Martin Pascoe QC and Alex Riddiford (instructed by **DaySparkes**) for the **Claimants**
Jeremy Goldring QC and Stephen Robins (instructed by **Reed Smith LLP**) for the **First Defendant**
David Head QC (instructed by **Hogan Lovells International LLP**) for the **Second Defendant**
Andrew de Mestre (instructed by **Norton Rose Fulbright LLP**) for the **Third Defendant**

Hearing dates: 9-11 March 2016

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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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MR JUSTICE SNOWDEN

MR JUSTICE SNOWDEN :

1. This is the expedited trial of seven issues in a Part 8 Claim issued in the Financial List. The issues concern the rights attaching to the "Class X Note" in a Commercial Mortgage-Backed Securitisation (CMBS) structure called "Windermere VII" that was arranged in 2006 by Lehman Brothers International (Europe) ("LBIE"). The issues are potentially of wider market significance, since the use of class X notes is not uncommon in CMBS structures, and such use in the earlier generation of CMBS structures created prior to 2008 has not been without controversy.

2. The main protagonists are the Claimants (together "Hayfin"), who are the current holder of the Class X Note, and the First Defendant ("the Issuer") which is a special purpose vehicle which was incorporated in Ireland in February 2006. The other parties are the Second Defendant (the "Note Trustee") and the Third Defendant (the "Cash Manager") who have taken a neutral stance in the argument.

3. The issues before the court are, or derive from, questions of interpretation of the complex CMBS documentation. They essentially concern the correct computation of the payments to be made to the holder of the Class X Note on two quarterly interest payment dates in January and October 2015. There are no material disputes of fact relevant to the determination of the questions of construction, and the parties have co-operated to bring the case on urgently so that a ruling could be given prior to the maturity date of the Notes on 22 April 2016.

CMBS Structures

4. Some of the basic generic features of a CMBS structure were helpfully summarised by Arnold J in Deutsche Trustee Company Limited v Cheyne Capital (Management) UK LLP [2015] EWHC 2282 (Ch) at paragraphs 3-8. In outline,

   i) CMBS transactions are securitisations which involve the acquisition of one or more loans secured upon income-generating commercial real estate, by a special purpose vehicle which funds the acquisition of the loans through the issue of notes to debt capital market investors.

   ii) Payments of interest on, and repayments of principal in respect of, the notes are funded through payments of interest on and repayments of principal in respect of the underlying loans, which in turn are funded by the cash-flow generated by the relevant commercial real estate.

   iii) The issuer in a CMBS transaction is typically an orphan special purpose vehicle without employees to manage the loan exposures. The management of the underlying loans is therefore outsourced to a "servicer".

   iv) Notes in CMBS transactions are typically issued in multiple classes. The allocation of principal receipts on the loans towards payments of principal on the notes is typically governed by complex rules that, in a pre-loan default situation, allocate loan principal receipts to the various classes of notes partly on a sequential basis and partly on a pro-rata basis but, following a loan default, on a fully sequential basis, with the most senior class of notes being

paid first in priority and the most subordinate class of notes being paid last in priority.

v) As would be expected, the more junior notes, with lower ratings, pay a higher marginal rate over the applicable base interest rate than the more senior notes.

5. The typical documentation to be found in a CMBS includes,

i) A note trust deed made between the issuer and a trustee for the noteholders containing the terms and conditions of the notes.

ii) A deed of charge and assignment between the issuer and the note trustee.

iii) The underlying mortgage loan agreements with the borrowers.

iv) A servicing agreement between the issuer, the note trustee and the servicer.

v) A cash management agreement.

vi) A liquidity facility providing short-term liquidity.

vii) A master definitions agreement.

The combined effect of this documentation will be set out and explained (often at great length) in an offering circular issued by or on behalf of the issuer. That document does not, however, normally constitute a contractual document.

The Windermere VII CMBS

6. The following summary of the Windermere VII CMBS and the issues which have arisen is largely taken from the statement of facts which has been agreed between the parties. I shall endeavour to use the same definitions as in the original documentation.

The Notes

7. Pursuant to a trust deed dated 16 May 2006 between the Issuer and the Note Trustee (the "Trust Deed"), the Issuer issued eight series of notes with an aggregate nominal amount of €782,500,000 (the "Notes"). The payment obligation under all of the Notes is owed by the Issuer solely to the Note Trustee. The rights attaching to the Notes are identified in the terms and conditions of the Notes (the "Conditions"), which form part of the Trust Deed.

8. All of the classes of Notes except the Class X Note have principal amounts running into many millions of euros, and pay interest at a floating rate of 3 month EURIBOR plus a margin, ranging from 0.13% (in the case of A1 Notes) to 3.40% (in the case of the F Notes). These Notes are referred to in the documentation as the "Regular Notes". The Regular Notes were issued to the capital markets and the underlying owners of interests in the Regular Notes hold their interests through the clearing systems.

9. In contrast to the Regular Notes, the Class X Note has a principal amount of only €50,000 and does not pay a rate of interest in any conventional sense. In general

terms it is designed to pay out to its holder the excess interest (if any) which is expected to arise in the hands of the Issuer from the underlying commercial mortgage loans in the relevant interest period, over and above the amounts that the Issuer is obliged to pay in respect of certain fees and costs of the CMBS structure and the amounts of interest payable on the Regular Notes. The Class X Note was not issued into the capital markets together with the Regular Notes, but was originally retained by LBIE as the arranger of the Windermere VII CMBS.

The Portfolio of Mortgage Loans

10. On about 16 May 2006, the Issuer used the proceeds of the issue of the Regular Notes to purchase interests in a number of commercial European mortgage loans to various borrowers (the "Mortgage Loans" and the "Borrowers"). The Mortgage Loans were secured by charges and other forms of security over assets including properties in Germany, Sweden, France and Spain (the "Security"). The entirety of each of the Mortgage Loans was securitised by way of the CMBS, save in respect of three Borrowers, where the Mortgage Loans were split (or "tranched") into a senior loan and a junior loan. In respect of these loans, only the senior loan was transferred to the Issuer and securitised: the junior loan was sold to a specific lender or lenders. The respective positions of the senior and junior lenders in respect of each of the tranched Mortgage Loans was regulated by a separate intercreditor agreement.

11. A number of service providers were appointed by the relevant parties to deal with the management of the underlying Mortgage Loans, the handling of monies and the payment of the Notes over the life of the transaction. In particular, a servicer was appointed to manage and collect payments of interest and principal from the Borrowers in respect of the Mortgage Loans, and the Cash Manager was appointed to handle payments and to determine the interest payable on the Notes.

The Nordostpark Mortgage Loan

12. Among the Mortgage Loans acquired by the Issuer was part of a loan (the "Nordostpark Mortgage Loan") made by Lehman Brothers Bankhaus AG ("Bankhaus") by a euro facility agreement dated 24 August 2005 ("the Facility Agreement") for acquisition of a commercial property consisting of office buildings at a business park ("Nordostpark") in Nuremberg, Germany. The Nordostpark Mortgage Loan was due for repayment by the borrower (the "Nordostpark Borrower") on 15 October 2012.

13. At the time of the securitisation, the total lending to the Nordostpark Borrower was €65,505,000 which was divided into a senior loan of €50,505,000 (the "Senior Loan") and a junior loan of €15,000,000 (the "Junior Loan"). The Senior Loan was sold by Bankhaus to the Issuer for securitisation by the issue of the Notes, and the Junior Loan was sold to other entities (the "Junior Lenders"). The relationship between the Issuer and the Junior Lenders was governed by an intercreditor agreement (the "Intercreditor Agreement"), which provided that the Senior Loan ranked in priority to the Junior Loan. Under that Intercreditor Agreement, all monies collected from the Nordostpark Borrower were to be paid into a "Tranching Account" to enable them to be divided between the Issuer and the Junior Lenders. The portion of the receipts to which the Issuer was entitled was required to be paid into a "Transaction Account" in the name of the Issuer.

14. Interest was payable on the whole of the Nordostpark Mortgage Loan by the Nordostpark Borrower under clauses 8.1 and 8.2 of the Facility Agreement at a rate of 4.4475% per annum (comprising a Fixed Rate of 2.9975% per annum and a fixed Margin of 1.45% per annum), plus an additional amount referred to as the "Mandatory Cost".

15. Clause 8.3 of the Facility Agreement then provided for the payment of Default Interest by the Borrower as follows,

> "8.3.1 If the Borrower fails to pay any amount payable by it under a Finance Document on its due date, interest shall accrue on the overdue amount from the due date up to the date of actual payment (both before and after judgment).
>
> 8.3.2 Interest on an overdue amount is payable at a rate determined by the Agent to be the higher of:
>
> > (A) one per cent per annum above the rate which would have been payable if the overdue amount had, during the period of non-payment, constituted a Loan in the currency of the overdue amount; and
> >
> > (B) one per cent per annum above the aggregate of the applicable Margin, EURIBOR and the Mandatory Costs, if applicable, for the same period.
>
> …
>
> 8.3.4 Default interest (if unpaid) arising on an overdue amount will be compounded with the overdue amount at the end of each Interest Period applicable to that overdue amount but will remain immediately due and payable."

The Nordostpark Interest Rate Swap

16. The Issuer was exposed to fluctuations in EURIBOR by its obligations under the Notes, but the interest payable by the Nordostpark Borrower was (at least prior to any payment default) to be a fixed rate. Accordingly, to provide a hedge, a swap agreement ("the Swap Agreement") was entered into to swap the Fixed Rate of 2.9975% payable on the entirety of the Nordostpark Mortgage Loan under the Facility Agreement for EURIBOR. The fixed Margin of 1.45% payable by the Nordostpark Borrower under the Facility Agreement was not swapped.

17. The manner in which the Swap Agreement was effected, and its benefit shared with the Junior Lender, was described in clause 13.4 of the Intercreditor Agreement as follows,

> "13.4.1 Each of the Lenders acknowledges and agrees:
>
> (a) that [Bankhaus] entered into (i) a swap dated 24 August 2005 in the notional principal amount of €66,000,000 (with an amortising schedule) with

Lehman Brothers Special Financing Inc as counterparty under which [Bankhaus] swapped (or, in effect, swapped) fixed rate receipts of interest under the Facility Agreement for floating rate receipts;

(b) pursuant to a confirmation dated 16 May 2006, [Bankhaus] has transferred or novated the entire benefit and burden of that swap (in respect of which the Senior Lenders have, inter alia, the benefit of Clause 12.3.1 (*Withdrawals from Tranching Account*) and Clause 17.1.2 (*Payments after Event of Default*) to the [Issuer];

(c) all receipts under such cap shall be paid to the Agent which shall credit the same to the Tranching Account to be applied subject as provided in this Deed; and

(d) such arrangements are Hedging Arrangements (as defined in the Facility Agreement) as between the [Issuer] and each of the Junior Lenders so as to provide the effective benefit of the above-mentioned swap and cap to the Junior Lenders as specified above.

13.4.2 [The Issuer] may, following the occurrence of an Event of Default or as a result of the Borrower repaying or prepaying the whole or any part of the Loan prior to maturity, terminate, unwind or liquidate the above mentioned swap agreement (or any replacement thereof)."

18. The Swap Agreement was scheduled to expire on 22 October 2012 (a week after the maturity date in respect of the Nordostpark Mortgage Loan). At the time that the Swap Agreement was transferred to the Issuer in May 2006, 3-month EURIBOR averaged about 2.89%.

The Default on the Nordostpark Mortgage Loan and subsequent events

19. Towards the end of the Nordostpark Mortgage Loan, the Nordostpark Borrower ran into financial difficulties, and a "special servicer" took over the responsibility for the management and administration of the Nordostpark Mortgage Loan on 21 November 2011. Two critical events then occurred which have given rise to a number of the issues in this case. First, the principal due on the Nordostpark Mortgage Loan was not repaid on the loan maturity date of 15 October 2012. This constituted an "Event of Default" under the Facility Agreement in relation to the Nordostpark Mortgage Loan. Secondly, shortly thereafter, on 22 October 2012, the Swap Agreement expired. By that date, however, 3-month EURIBOR had fallen to about 0.2% - well below the Fixed Rate payable by the Nordostpark Borrower under the Facility Agreement - and the Swap Agreement was not replaced.

20. The CMBS structure continued in this state for several years. As at the January 2015 Payment Date, out of the original Loans, only three remained subject to the CMBS:

the Nordostpark Mortgage Loan and two others called the "Adductor" and "Mülheim" Mortgage Loans.

21. By that Payment Date, substantial amounts of principal had been repaid on the Notes, but the following principal amounts were still outstanding:

Tranche Class Name	Ending Principal Balance (€)
A1	0.00
A2	14,126,496.20
X	50,000.00
B	33,464,737.53
C	18,338,676.17
D	34,000,173.33
E	10,559,356.73
F	0.00

22. The Class X Note had been sold by LBIE after the collapse of Lehman Brothers. On the January 2015 Payment Date, the holder of the Class X Note received a payment of €474,052.01 in respect of the "Class X Interest Amount" (as defined in the Conditions). I shall return to consider the meaning of that definition in greater detail below.

23. In April 2015 both parts of the Nordostpark Mortgage Loan were sold to a third party, so that between 22 April 2015 and the October 2015 Payment Date, only the Adductor and Mülheim Mortgage Loans remained subject to the CMBS.

24. In mid-July 2015, Hayfin purchased the Class X Note. By September 2015 Hayfin had also acquired 34.34% of the principal amount outstanding of the Class B Notes.

25. At the July 2015 Payment Date, Hayfin received payment of €486,862.69 in respect of the Class X Interest Amount.

26. By the October 2015 Payment Date, further repayments of principal had taken place, so that the following principal amounts were outstanding on the various classes of Notes:

Tranche Class Name	Ending Principal Balance (€)
A1	0.00
A2	0.00
X	50,000.00
B	5,019,225.38
C	18,338,676.17
D	34,000,173.33
E	10,559,356.73

F	0.00

27. In the third quarter of 2015, €1,843,664.10 of unpaid interest in respect of the Adductor Loan was capitalised. The Issuer has stated that this was carried out in accordance with clause 22.3 of the Adductor Mortgage Loan Agreement (which was governed by French law) and Article 1154 of the French Civil Code. From a computation provided by the Issuer, it would seem that this capitalisation was taken to have reduced the cumulative amount of interest due and payable to the Issuer in respect of the Adductor Mortgage Loan for the October 2015 Payment Date to €2,235,314.29. The inference is that without the capitalisation, the amount of interest due and payable on that date would have been €4,078,978.39.

28. The Issuer's calculation of the Class X Interest Amount for the October 2015 Payment Date was then based upon the lower amount of cumulative interest due and payable under the Adductor Mortgage Loan Agreement and resulted in a Class X Interest Amount of zero. Had the larger number been used, on the Issuer's numbers, the Class X Interest Amount would have been €331,092.21; on Hayfin's slightly different numbers, the Class X Interest Amount would have been €525,933.

The Issues

29. Since acquiring its interest in the Class X Note and the Class B Notes, Hayfin has advanced a number of arguments as to how the amounts payable on the Class X Note should have been calculated, and has contended that the amounts paid by the Issuer on the Class X Note have been inadequate. Those arguments have given rise to the issues to be decided in this case. They relate to two sample Payment Dates of January and October 2015.

30. The first five issues concern the computation of the amounts payable on the Class X Note. The first three relate to the January 2015 Payment Date and turn on the interpretation of the Intercreditor Agreement in relation to the Nordostpark Mortgage Loan. The fourth and fifth issues relate to the October 2015 Payment Date and relate to the capitalisation of interest on the Adductor Mortgage Loan.

31. The last two issues will only have any consequence if it is determined that there have been underpayments in respect of the Class X Note in the past. In that event, the sixth question is whether any such unpaid amounts carry interest and if so, at what rate; and the seventh is whether any such underpayment(s) constituted an Event of Default in relation to the Notes, with the result that the Note Trustee would be entitled or obliged to serve a Note Enforcement Notice in respect of the Notes.

32. In passing I should mention that although the questions of construction concern the Intercreditor Agreement, the Junior Lenders who were parties to that agreement have not been joined to proceedings. I was told that this is because there are no longer any payments left to be made under the Nordostpark Mortgage Loan which might be affected by the view that I take of the meaning of the Intercreditor Agreement. I was also told that the parties to this claim would consider any potential implications for the position of the Junior Lenders in light of my judgment (which of course does not bind them in any event).

Background: class X notes

33. By way of general background to the construction issues raised in this case, it appears that the use of "class X notes" in older CMBS structures has not been free from controversy. In *Peterson, Commercial Mortgage Loans and CMBS: Developments in the European Markets* (2nd ed, 2012), the author commented on a number of the features of the first generation of CMBS transactions that had given rise to issues since the financial crisis commencing in 2008,

> "CMBS transactions are typically structured so that the aggregate interest that accrues on the loans exceeds the aggregate amount of interest that accrues on the CMBS notes and certain CMBS level expenses. This excess amount is commonly referred to as the excess spread. One of the most contentious issues in existing CMBS transactions has been the extraction of excess spread by the arranging bank or the creation of tradable securities out of the excess spread which are then sold or retained by the arranging bank to third parties. Many CMBS transactions provided revenue for the originating or arranging bank through the extraction or sale of at least a portion of this excess spread and this revenue stream was structured and defined in a number of ways including class X notes, deferred consideration, residual interest or retained interest. Whilst part of this revenue stream could be utilised to recover certain upfront transaction costs of the CMBS transaction, it could also yield significant profits for arranging banks, and certain class X note structures have permitted ongoing revenue extraction even when the underlying notes are stressed or distressed and there are significant shortfalls to noteholders or liquidity facility drawings.
>
> The main historical issues with such revenue streams and in particular class X notes have been the lack of disclosure of the detailed structure, certain structural features (e.g. how extraneous expenses are met) that potentially result in shortfalls for noteholders which would otherwise be met by excess spread, shortfalls to noteholders or liquidity facility drawings at a time when the beneficiary of the revenue stream continues to receive payments, and the potential for default interest, consent fees, increased margins and ongoing excess spread to be paid to such beneficiary after the loan maturity."

Background: the Windermere VII Offering Circular

34. The explanation of the rights attaching to the Class X Note in the Windermere VII offering circular essentially replicated the relevant Conditions relating to the Note. The focus of the Risk Factors identified in relation to the Class X Note was on the relationship between the rates of interest payable on the Regular Notes and the amounts of interest payable under the Mortgage Loans,

> "Class X Note. The Class X Interest Rate will be highly sensitive to, among other things, an increase in the weighted average of the Note Rates of Interest of the Regular Notes arising from the sequential prepayment of the Notes under the Issuer Sequential Principal Pre-Enforcement Priority of Payments. Interest will cease to be payable on the Class X Note if the aggregate of the Issuer's expenses in items (i) through (xiv) inclusive of the Issuer Revenue Pre-Enforcement Priority of Payments (excluding item (vii)(c)) equals or exceeds, at any time, the interest payable on the Mortgage Loans ...
>
> …
>
> The yield to maturity on the Class X Note will be highly sensitive to the rate and timing of principal payments and collections (including by reason of a voluntary or involuntary prepayment, or a default or liquidation) on the Mortgage Loans. Investors in the Class X Note should fully consider the associated risks, including the risk that a faster than anticipated rate of principal payments and collections could result in a lower than expected yield and an early liquidation of the Mortgage Loans could result in the failure of such investors to fully recoup their initial investments."

35. The only mention of the potential impact of the Swap Agreement was in the same section of the offering circular, as follows,

> *"Hedging Considerations.* In order to address interest rate and currency risks, the Issuer will enter into the Interest Rate Swap Agreement and the Currency Swap Agreement … However there can be no assurance that the Interest Rate Swap Agreement and the Currency Swap Agreement will adequately address unforeseen hedging risks.
>
> In certain circumstances, including where the Issuer, the Currency Swap Provider or the Interest Rate Swap Provider may be required to pay additional amounts in respect of tax or where there is a substantial likelihood that payments from either such party may be subject to tax withholding, the Interest Rate Swap Agreement and/or the Currency Swap Agreement may be terminated. If the Interest Rate Swap Agreement and/or the Currency Swap Agreement is terminated, no assurance can be given that the issuer will have sufficient funds in order to enable it to make, inter-alia, the required payments on the Notes."

The general approach to interpretation

36. Before turning to the specific issues, I should say a little about the approach to the interpretation of commercial agreements in general, and to the application of the general principles to the interpretation of tradeable financial instruments in particular.

37. I was referred to a number of cases of high authority in this area, including Investors Compensation Scheme Ltd v West Bromwich Building Society [1998] 1 WLR 896; Attorney-General of Belize v Belize Telecom Ltd [2009] 1 WLR 1988 ("Belize Telecom"); Chartbrook Ltd v Persimmon Homes Ltd [2009] 1 AC 1101 ("Chartbrook"); Re Sigma Finance Corp [2010] 1 All ER 571 ("Sigma"); Napier Park European Credit Opportunities Fund Limited v Harbourmaster Pro-Rata CLO 2 BV [2014] EWCA Civ 984 ("Napier Park"); Arnold v Britton [2015] AC 1619 ("Arnold v Britton"); and Marks and Spencer PLC v BNP Paribas Securities Services Trust Co (Jersey) Ltd [2015] 3 WLR 1843 ("M&S v BNP").

38. The general approach to interpretation of commercial contracts and documents is well-known. In Arnold v Britton at paragraph 15, Lord Neuberger said,

> "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 in Chartbrook, para 14. 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 [contract], (iii) the overall purpose of the clause and the [contract], (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."

39. Lord Neuberger went on to emphasise seven factors which were of particular relevance to the interpretation of the lease in issue in Arnold v Britton. Of those, the first four are also relevant when interpreting commercial documents which form part of the structure underpinning tradeable financial instruments of the type in issue in this case, where there is a premium to be placed upon the language actually used in the instrument,

> "17. First, the reliance placed in some cases on commercial common sense and surrounding circumstances (eg in Chartbrook, paras 16-26) should not be invoked to undervalue the importance of the language of the provision which is to be construed. The exercise of interpreting a provision involves identifying what the parties meant through the eyes of a reasonable reader, and, save perhaps in a very unusual case,

that meaning is most obviously to be gleaned from the language of the provision. Unlike commercial common sense and the surrounding circumstances, the parties have control over the language they use in a contract. And, again save perhaps in a very unusual case, the parties must have been specifically focussing on the issue covered by the provision when agreeing the wording of that provision.

18. Secondly, when it comes to considering the centrally relevant words to be interpreted, I accept that the less clear they are, or, to put it another way, the worse their drafting, the more ready the court can properly be to depart from their natural meaning. That is simply the obverse of the sensible proposition that the clearer the natural meaning the more difficult it is to justify departing from it. However, that does not justify the court embarking on an exercise of searching for, let alone constructing, drafting infelicities in order to facilitate a departure from the natural meaning. If there is a specific error in the drafting, it may often have no relevance to the issue of interpretation which the court has to resolve.

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. Experience shows that it is by no means unknown for people to enter into arrangements which are ill-advised, even ignoring the benefit of wisdom of hindsight, and it is not the function of a court when interpreting an agreement to relieve a party from the consequences of his imprudence or poor advice. 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."

40. Lord Neuberger's fifth point in Arnold v Britton concerned the permissible use of the background facts known or reasonably available to both of the contracting parties. In cases involving traded financial instruments, such matters are obviously far less

relevant than in the case of a bilateral contract. That point, together with the correct approach to the evaluation of the commercial consequences of the rival interpretations was clearly made by Lewison LJ in Napier Park at paras 31-32,

> "31. The approach to the interpretation of a tradable financial instrument of this kind was authoritatively considered by the Supreme Court in Sigma. In that case Lord Mance, approving Lord Neuberger's dissenting judgment in the Court of Appeal, said at [12]:
>
> > "Lord Neuberger was right to observe that the resolution of an issue of interpretation in a case like the present is an iterative process, involving "checking each of the rival meanings against other provisions of the document and investigating its commercial consequences"."
>
> 32. The iterative process thus described is not confined to textual analysis and comparison. It extends also to placing the rival interpretations within their commercial setting and investigating (or at any rate evaluating) their commercial *consequences*. That is not to say that in a case like this the commercial setting should be derived from considerations outside the four corners of the contractual documents. As Lord Collins said in the same case at [37]:
>
> > "Consequently this is not the type of case where the background or matrix of fact is or ought to be relevant, except in the most generalised way. … Where a security document secures a number of creditors who have advanced funds over a long period it would be quite wrong to take account of circumstances which are not known to all of them. In this type of case it is the wording of the instrument which is paramount. The 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. Detailed semantic analysis must give way to business common sense…""

Issue 1(1): The Meaning of "Senior Rate" and "Junior Rate"

41. The first issue, as formulated by the parties, is,

> "Whether, as a matter of construction, for the purpose of calculating the Expected Available Interest Collections in respect of the Nordostpark Mortgage Loan for the January 2015 Payment Date (and accordingly for the purpose of determining the amount of interest due and payable on the Class X Note)

element (b) of the definitions of "Senior Rate" and "Junior Rate" in the Nordostpark Intercreditor Agreement should be interpreted (or a term implied therein) so as to mean,

> *"EURIBOR or (where no Hedging Arrangement remains in place) the Fixed Rate or (following an Event of Default where no Hedging Arrangement remains in place), the higher of EURIBOR and the Fixed Rate."*"

42. It is apparent from the wording of the issue that although Hayfin's contention relates to the amounts payable on the Class X Note which it now holds, its arguments depend upon the definition of "Expected Available Interest Collections" in the Conditions, and that in turn is affected by the definitions of "Senior Rate" and "Junior Rate" in the Intercreditor Agreement. In order to understand the connection between these terms and what Hayfin seeks to achieve by its arguments concerning the terms of the Intercreditor Agreement, it is unfortunately necessary to set out a number of other defined terms in the documentation.

43. Turning first to the amounts of interest payable on the Notes, the relevant provision of the Conditions as regards interest is,

> "Each Class of Notes will accrue interest during each Interest Period at the rate of (A) in the case of the Regular Notes, EURIBOR (as defined below) plus the Relevant Margin (as defined below) for that class and (B) in the case of the Class X Note, at the Class X Interest Rate."

44. As indicated, the Regular Notes all carry interest calculated in a conventional manner using an interest rate based upon EURIBOR plus the Relevant Margin. That is not the case with the Class X Note, where no conventional interest rate is specified to be payable on the outstanding principal of the Note. Instead, the key definition is that of the "Class X Interest Amount", which is defined to mean,

> " … with respect to any Interest Period, the greater of (a) zero and (b) the excess (if any) of the Expected Available Interest Collections for such Interest Period over the amounts due and payable by the Issuer in accordance with items (i) to (xiv) inclusive (excluding item (vii)(c)) of the Issuer Revenue Pre-Enforcement Priority of Payments for such Interest Period."

45. The second part of that definition essentially corresponds to all amounts of costs, fees and expenses payable to the other parties involved with the administration of the Notes and the interest payable on the Regular Notes, so that the Class X Interest Amount payable on the Class X Note is the excess (if any) of the "Expected Available Interest Collections" over and above those amounts.

46. The crucial definition of "Expected Available Interest Collections" is,

> " … with respect to an Interest Period, the amount of Available Interest Collections that would have been available on the Payment Date falling at the end of such Interest Period, assuming full and timely payment by the Borrowers of interest due and payable on the Mortgage Loans on the relevant Loan Payment Date falling in such Interest Period."

47. In turn the definition of "Available Interest Collections" is to be found in the Master Definitions Agreement as follows,

> ""Available Interest Collections" means, on each Payment Date prior to the service of a Note Enforcement Notice:
>
> (a) all Borrower Interest Collections transferred by or at the direction of the Master Servicer and the Issuer into the Transaction Account during the Collection Period ended immediately before such Payment Date (less any Borrower Interest Collections applied during such Collection Period in payment of any Revenue Priority Amounts);
>
> (b) all Swap Amounts paid on such Payment Date (other than amounts attributable to swap collateral (and income thereon));
>
> (c) the proceeds of any Income Deficiency Drawings made under and in accordance with the Liquidity Facility Agreement in respect of such Payment Date; and
>
> (d) any interest accrued upon and paid to the Issuer on the Transaction Account, the Stand-by Account and the income from any Eligible Investments (other than the proceeds of any Eligible Investments of the Class X Interest Amount),
>
> and as determined by the Cash Manager on the basis of, inter alios, the information provided by the Master Servicer, and which will be applied in accordance with the Issuer Revenue Pre-Enforcement Priority of Payments."

48. The "Borrower Interest Collections" are defined to mean,

> "… all payments of interest, fees (other than Prepayment Fees and Extension Fees), breakage costs, expenses, commissions and other sums paid by a Borrower in respect of the Mortgage Loans or the Related Security (other than any payments in respect of principal), including recoveries in respect of such amounts on enforcement of such Mortgage Loan or the Related Security."

49. From these definitions, it follows that it is only once the Class X Interest Amount has been determined that it is possible to determine the Class X Interest Rate in relation to any particular Interest Period. That number is simply defined as,

> "…with respect to each Interest Period, the percentage calculated by multiplying a fraction, the numerator of which is the Class X Interest Amount and the denominator of which is the Principal Amount Outstanding of the Class X Note, by 100."

50. It is readily apparent that the amount of the Expected Available Interest Collections is based upon an assumption being made that there has been "full and timely payment by the Borrowers of interest due and payable on the Mortgage Loans on the relevant Loan Payment Date falling in such Interest Period". The definition of Borrower Interest Collections likewise focusses attention on "all payments of interest … paid by a Borrower in respect of the Mortgage Loans" and excludes "any payments in respect of principal". Having made that assumption and that distinction, the amount of the Expected Available Interest Collections will depend upon the amount of such (assumed) payments of interest that would be transferred into the Issuer's Transaction Account.

51. This calculation therefore focusses attention upon the manner in which the Intercreditor Agreement provides for payments of interest by the Nordostpark Borrower to be dealt with. The relevant provisions of the Intercreditor Agreement in that regard can, for analysis, be divided into clauses applying when no Event of Default under the Facility Agreement is continuing, and those applying when an Event of Default has occurred and is continuing.

52. In that regard, clause 12.1 provides for the creation and maintenance of the Tranching Account by the Issuer. Clause 12.2 provides for the Agent to ensure that all amounts received from the Borrower under the Facility Agreement are paid into the Tranching Account and for the Issuer to ensure that all amounts received under the Swap Agreement are paid into the Tranching Account. Clause 12.3 then provides,

> "12.3 Withdrawals from Tranching Account
>
> Any amount standing to the credit of the Tranching Account shall, if no Event of Default is continuing, be applied by the Senior Agent on each Payment Date in the following order:
>
> 12.3.1 first, in payment of any unpaid fees, costs and expenses of the Lenders (including, for the avoidance of doubt, costs, termination payments and expenses under any Hedging Arrangement effected by or novated in favour of or otherwise entered into by a Senior Lender in relation to the Loan or any part thereof), the Agent (including any amounts payable to the Agent under Clause 3.2 (Indemnity), the Servicer and/or the Special Servicer under the Finance Documents, the Servicing Agreement and this Deed;
>
> 12.3.2 second, in payment to the Lenders of accrued interest at the Senior Rate and the relevant Junior Rate for the relevant interest period (for the avoidance of doubt, any Hedge Receipt standing to the credit of the

Tranching Account may be used in such payment, irrespective of the Hedging Arrangement to which such Hedge Receipt is referable);

12.3.3 third, in payment to the Lenders in accordance with this Deed of any principal payment received from the Obligors under the Finance Documents; and

12.3.4 fourth, in payment to the Lenders of any other amounts due but unpaid under the Finance Documents but subject as provided in this Deed."

53. The regime which applies in the event of a continuing Event of Default is set out in the next section of the Intercreditor Agreement headed "Post-Default and Enforcement". Clause 17 provides for a "post-default waterfall" of amounts to which any monies received will be applied, as follows,

> "If an Event of Default has occurred and is continuing, the Agent, or as the case may be, the Senior Agent will on each Interest Payment Date or promptly on receipt apply all amounts received in respect of the Finance Documents including all amounts standing to the credit of the Control Accounts, the Tranching Account and, subject to Clause 18 (*Escrow*), the Escrow Account and, subject to the rights of any creditor with prior security or any preferential claim, the proceeds of any enforcement of Security in the following order:
>
> 17.1.1 first, in or towards any fees, costs and expenses of the Agent and any receiver which are then due and payable under the Finance Documents including any fees, costs or expenses of the Servicer and/or the Special Servicer;
>
> 17.1.2 second, in or towards any fees, costs and expenses of the Senior Lenders (including, for the avoidance of doubt, costs, termination payments and expenses under any Hedging Arrangement effected by or novated in favour of or otherwise entered into by a Senior Lender in relation to the Loan or any part thereof) which are then due and payable under the Finance Documents;
>
> 17.1.3 third, in or towards payment to the Senior Lenders of any accrued but unpaid interest at the Senior Rate (excluding Default Interest) on the Senior Loan;
>
> 17.1.4 fourth, in or towards payment of any principal amount due but unpaid on the Senior Loan (other than Excess Senior Loan);
>
> 17.1.5. fifth, in or towards payment of any accrued but unpaid interest at the Junior A Rate due on each respective Junior A Loan;

17.1.6. sixth, in or towards payment of any principal amount due but unpaid on each Junior A Loan;

17.1.7 seventh, in or towards payment of any accrued but unpaid interest at the Junior B Rate due on each respective Junior B Loan;

17.1.8 eighth, in or towards payment of any principal amount due but unpaid on each Junior B Loan;

17.1.9 ninth, in or towards payment of any accrued but unpaid interest at the Junior C Rate due on each respective Junior C Loan;

17.1.10 tenth, in or towards payment of any principal amount due but unpaid on each Junior C Loan;

17.1.11 fifteenth, [sic] in or towards payment of any Senior Loan to which a Junior Lender has or Junior Lenders have been subrogated by virtue of making a Cure Payment (other than Default Interest) pro rata and pari passu to the Junior Lenders who have made the Cure Payments;

17.1.12 sixteenth, [sic] in or towards payment of any Default Interest due but unpaid to the Senior Lenders;

17.1.13 seventeenth, [sic] in or towards payment of any Default Interest due but unpaid to the Junior A Lenders;

17.1.14 eighteenth, [sic] in or towards payment of any Default Interest due but unpaid to the Junior B Lenders;

17.1.15 nineteenth, [sic] in or towards payment of any Default Interest due but unpaid to the Junior C Lenders;

17.1.16 twentieth, [sic] in or towards payment of any other due but unpaid Senior Loan (other than Excess Senior Loan);

17.1.17 twenty first, [sic] in or towards payment of any other due but unpaid Junior A Loan;

17.1.18 twenty second, [sic] in or towards payment of any other due but unpaid Junior B Loan;

17.1.19 twenty third, [sic] in or towards payment of any other due but unpaid Junior C Loan;

17.1.20 twenty fourth, [sic] in or towards payment of any other due but unpaid Senior Loan; and

17.1.21 twenty fifth, [sic] in or towards payment of any Excess Senior Loan."

54. It can be seen that in both of the pre- and post- Event of Default scenarios, interest is payable to the Issuer and the Junior Lenders at the "Senior Rate" and "Junior Rate" respectively (see clause 12.3.2 and clauses 17.1.3. 17.1.5, 17.1.7 and 17.1.9 of the post-default waterfall). Those terms are defined in clause 1.2 of the Intercreditor Agreement. Senior Rate is defined as follows:

> ""Senior Rate" means, for any Interest Period, the aggregate of:
>
> (a) The higher of:
>
> (i) 0.77 per cent. per annum, and
>
> (ii) the percentage rate per annum which is equal to *a* where:
>
> $$a = \frac{((bc) - (de))}{f}$$
>
> *b* = the Margin;
>
> *c* = the aggregate principal amount outstanding under the Facility Agreement during that Interest Period;
>
> *d* = the average of the percentage per annum specified in each Junior Rate Side Letter as applied to each outstanding principal balance of each Junior Loan less the Servicing Margin;
>
> *e* = the aggregate principal amount of the Junior Loans outstanding during that Interest Period;
>
> *f* = the aggregate principal amount of the Senior Loan outstanding during that Interest Period; and
>
> (b) EURIBOR; and
>
> (c) Mandatory Costs (if any),
>
> in the case of (c) above, as determined in accordance with the Facility Agreement."

55. "Junior Rate" is defined as a Junior A Rate, a Junior B Rate or a Junior C Rate as the case may be. This is a reference to three separate A, B and C portions into which the Junior Loan is divided, each of which is the subject of a separate Junior Rate Side

Letter. Each of the definitions of the Junior A Rate, the Junior B Rate and the Junior C Rate is in the same form, as follows,

> ""Junior [A][B][C] Rate" means with respect to any Interest Period, the aggregate of:
>
> (a) the percentage per annum specified in the [relevant] Junior Rate Side Letter less the Servicing Margin;
>
> (b) EURIBOR; and
>
> (c) Mandatory Costs (if any),
>
> in the case of (c) above as determined in accordance with the Facility Agreement less an amount equal to all fees payable (calculated on a per annum basis) to the Special Servicer by the Junior Lender (acting by the Junior Agent) under the Servicing Agreement."

56. The effect of limb (a) of the two definitions of Senior Rate and Junior Rate is to divide the fixed Margin of 1.45% paid by the Borrower on the Mortgage Loan between the Issuer and the Junior Lenders. That part of the definitions is not in dispute between the parties. The issue between the parties has arisen in relation to limb (b) of the definitions.

57. At least whilst the Swap Agreement continued in existence, the simple reference in limb (b) of each of the definitions of Senior Rate and Junior Rate to "EURIBOR" was consistent with the Fixed Rate component of the interest payable by the Borrower on the whole of the Nordostpark Mortgage Loan having been swapped for a floating rate under the Swap Agreement (as expressly envisaged by clause 12.3.1 or clause 17.1.2) before the resultant monies were applied under clause 12.3.2 or paid down the post-default waterfall. The monies resulting from the interest rate swap in this way would in effect be divided pro rata between the Issuer (in respect of the Senior Loan) and the Junior Lenders (in respect of the Junior Loan). If there was no continuing Event of Default, the payments would be made from the Tranching Account to both of the Issuer and the Junior Lenders pursuant to clause 12.3.2. If there was a continuing Event of Default, the payment of interest would still be made to the Issuer in priority under clause 17.1.3, and, if sufficient monies were received, would be made to the Junior Lenders under clause 17.1.5, but only after prior payment of any principal amount due but unpaid on the Senior Loan under clause 17.1.4.

58. The issue in this case has arisen, however, because of the expiry of the Swap Agreement without replacement in 2012, and the dramatic fall of EURIBOR to well below the Fixed Rate payable by the Nordostpark Borrower on the Nordostpark Mortgage Loan. Hayfin does not suggest that there is any ambiguity in the relevant express terms of the Intercreditor Agreement, but it contends that in circumstances in which there is no Swap Agreement in force, the simple reference to "EURIBOR" in limb (b) of the definitions of Senior Rate and Junior Rate terms produces a mismatch between the Fixed Rate component of the interest payable by the Nordostpark Borrower on the Nordostpark Mortgage Loan and the division of such monies between the Issuer and the Junior Lenders by reference to a floating rate.

59. Hayfin contends (and produced a number of hypothetical worked examples to illustrate its contentions) that the consequences of this mismatch would be most evident if (as is now the case) EURIBOR is much lower than the Fixed Rate payable by the Nordostpark Borrower, and would result in a build-up of surplus interest payable by the Nordostpark Borrower under the Facility Agreement which would not be allocated between the Issuer and the Junior Lenders by the Intercreditor Agreement. Hayfin contends that the Issuer and the Junior Lenders must have intended to divide all of the interest payable by the Nordostpark Borrower between them, and that the possibility that substantial amounts of such interest paid might remain unallocated is a commercial absurdity.

60. Hayfin thus submitted that in order to eliminate the mismatch in the event of the Swap Agreement no longer being in place, between the Fixed Rate of interest payable by the Nordostpark Borrower and the floating rate of interest payable to the Issuer and the Junior Lenders under the Intercreditor Agreement, the definitions of Senior Rate and Junior Rate in the Nordostpark Intercreditor Agreement should be corrected by construction or by necessary implication by the addition of further words so that limb (b) of each definition reads,

> "EURIBOR or (where no Hedging Arrangement remains in place) the Fixed Rate or (following an Event of Default where no Hedging Arrangement remains in place), the higher of EURIBOR and the Fixed Rate".
>
> (emphasis added)

61. Hayfin's purpose in advancing this argument can be readily understood. As set out above, the Class X Interest Amount is to be calculated on a hypothetical assumption of full payment of interest due by the Nordostpark Borrower. What Hayfin seeks to establish is that if the Swap Agreement is no longer in existence, the amounts which would be payable into the Issuer's Transaction Account ought not to be calculated using the (very low) EURIBOR rate under limb (b) of the definitions of Senior Rate and Junior Rate in the Intercreditor Agreement, but should have been calculated using the (much higher) Fixed Rate payable by the Nordostpark Borrower. Given that the interest payable by the Issuer on the Regular Notes was computed by reference to EURIBOR, such increased payment under limb (b) would give rise to a substantial excess in the Transaction Account, thereby increasing the Class X Interest Amount.

62. Hayfin's contention that the relevant definitions of Senior Rate and Junior Rate can be "corrected by construction" is based upon the process of interpretation discussed by Lord Hoffmann in Chartbrook at paragraphs 22-25:

> "22. In East v Pantiles (Plant Hire) Ltd (1981) 263 EG 61 Brightman LJ stated the conditions for what he called "correction of mistakes by construction":
>
> > "Two conditions must be satisfied: first, there must be a clear mistake on the face of the instrument; secondly, it must be clear what correction ought to be made in order to cure the mistake. If those conditions are

> satisfied, then the correction is made as a matter of construction."

> 23. Subject to two qualifications, both of which are explained by Carnwath LJ in his admirable judgment in KPMG LLP v Network Rail Infrastructure Ltd [2007] Bus LR 1336, I would accept this statement, which is in my opinion no more than an expression of the common sense view that we do not readily accept that people have made mistakes in formal documents. The first qualification is that "correction of mistakes by construction" is not a separate branch of the law, a summary version of an action for rectification. As Carnwath LJ said, at p 1351, para 50:
>
> > "Both in the judgment, and in the arguments before us, there was a tendency to deal separately with correction of mistakes and construing the paragraph 'as it stands', as though they were distinct exercises. In my view, they are simply aspects of the single task of interpreting the agreement in its context, in order to get as close as possible to the meaning which the parties intended."
>
> 24. The second qualification concerns the words "on the face of the instrument". I agree with Carnwath LJ, paras 44–50, that in deciding whether there is a clear mistake, the court is not confined to reading the document without regard to its background or context. As the exercise is part of the single task of interpretation, the background and context must always be taken into consideration.
>
> 25. What is clear from these cases is that there is not, so to speak, a limit to the amount of red ink or verbal rearrangement or correction which the court is allowed. All that is required is that it should be clear that something has gone wrong with the language and that it should be clear what a reasonable person would have understood the parties to have meant."

63. For the Issuer, Mr. Goldring QC disputed that the terms of the Intercreditor Agreement disclosed any mistake (clear or otherwise), or that it was clear that a reasonable person would have understood the contracting parties to have meant that the definitions of Senior Rate and Junior Rate would include the additional wording suggested by Hayfin. To the contrary, he submitted that the singular reference to "EURIBOR" in limb (b) of each of those definitions was clear and unambiguous; that the terms of the Intercreditor Agreement showed that the parties had contemplated that the Swap Agreement might at some point not be in existence, but had chosen not to provide any further or alternative definitions of Senior Rate and Junior Rate to apply in that event; that it was not clear that the additional wording suggested by Hayfin was what the parties meant; and that the Intercreditor Agreement contained a mechanism for dealing with funds received from the Nordostpark Borrower which prevented any commercial absurdity.

64. Mr. Goldring also characterised Hayfin's contention that additional words should notionally be written into the Intercreditor Agreement as amounting to the implication of terms into the agreement. He submitted that Hayfin could not satisfy any of the strict requirements for implication of terms as recently set out by the Supreme Court in M&S v BNP. In that case, Lord Neuberger (whose judgment in this respect was agreed by all of the members of the Supreme Court) restated the law as to implied terms at paras 16-21,

> "16. There have, of course, been many judicial observations as to the nature of the requirements which have to be satisfied before a term can be implied into a detailed commercial contract. They include three classic statements, which have been frequently quoted in law books and judgments. In The Moorcock (1889) 14 PD 64, 68, Bowen LJ observed that in all the cases where a term had been implied, "it will be found that … the law is raising an implication from the presumed intention of the parties with the object of giving the transaction such efficacy as both parties must have intended that at all events it should have". In Reigate v Union Manufacturing Co (Ramsbottom) Ltd [1918] 1 KB 592, 605, Scrutton LJ said that "A term can only be implied if it is necessary in the business sense to give efficacy to the contract". He added that a term would only be implied if "it is such a term that it can confidently be said that if at the time the contract was being negotiated" the parties had been asked what would happen in a certain event, they would both have replied: "'Of course, so and so will happen; we did not trouble to say that; it is too clear.'" And in Shirlaw v Southern Foundries (1926) Ltd [1939] 2 KB 206, 227, MacKinnon LJ observed that, "Prima facie that which in any contract is left to be implied and need not be expressed is something so obvious that it goes without saying". Reflecting what Scrutton LJ had said 20 years earlier, MacKinnon LJ also famously added that a term would only be implied "if, while the parties were making their bargain, an officious bystander were to suggest some express provision for it in their agreement, they would testily suppress him with a common 'Oh, of course!'"
>
> 17. Support for the notion that a term will only be implied if it satisfies the test of business necessity is to be found in a number of observations made in the House of Lords. Notable examples included Lord Pearson (with whom Lord Guest and Lord Diplock agreed) in Trollope & Colls Ltd v North West Metropolitan Regional Hospital Board [1973] 1 WLR 601, 609, and Lord Wilberforce, Lord Cross of Chelsea, Lord Salmon and Lord Edmund-Davies in Liverpool City Council v Irwin [1977] AC 239, 254, 258, 262 and 266 respectively. More recently, the test of "necessary to give business efficacy" to the contract in issue was mentioned by Baroness Hale JSC in Geys

v. Société Générale [2013] 1 AC 523, para 55 and by Lord Carnwath JSC in Arnold v Britton, para 112.

18. In the Privy Council case BP Refinery (Westernport) Pty Ltd v Shire of Hastings (1977) 180 CLR 266, 282–283, Lord Simon of Glaisdale (speaking for the majority, which included Viscount Dilhorne and Lord Keith of Kinkel) said that:

> "for a term to be implied, the following conditions (which may overlap) must be satisfied: (1) it must be reasonable and equitable; (2) it must be necessary to give business efficacy to the contract, so that no term will be implied if the contract is effective without it; (3) it must be so obvious that 'it goes without saying'; (4) it must be capable of clear expression; (5) it must not contradict any express term of the contract."

19. In Philips Electronique Grand Public SA v British Sky Broadcasting Ltd [1995] EMLR 472, 481, Bingham MR set out Lord Simon's formulation, and described it as a summary which "distil[led] the essence of much learning on implied terms" but whose "simplicity could be almost misleading." Bingham MR then explained, at pp 481–482, that it was "difficult to infer with confidence what the parties must have intended when they have entered into a lengthy and carefully-drafted contract but have omitted to make provision for the matter in issue", because "it may well be doubtful whether the omission was the result of the parties' oversight or of their deliberate decision", or indeed the parties might suspect that "they are unlikely to agree on what is to happen in a certain … eventuality" and "may well choose to leave the matter uncovered in their contract in the hope that the eventuality will not occur." Bingham MR went on to say, at p 482:

> "The question of whether a term should be implied, and if so what, almost inevitably arises after a crisis has been reached in the performance of the contract. So the court comes to the task of implication with the benefit of hindsight, and it is tempting for the court then to fashion a term which will reflect the merits of the situation as they then appear. Tempting, but wrong. [He then quoted the observations of Scrutton LJ in the Reigate case, and continued] it is not enough to show that had the parties foreseen the eventuality which in fact occurred they would have wished to make provision for it, unless it can also be shown either that there was only one contractual solution or that one of several possible solutions would without doubt have been preferred …"

20. Bingham MR's approach in the Philips case was consistent with his reasoning, as Bingham LJ in the earlier case Atkins International HA v Islamic Republic of Iran Shipping Lines (The APJ Priti) [1987] 2 Lloyd's Rep 37, 42, where he rejected the argument that a warranty, to the effect that the port declared was prospectively safe, could be implied into a voyage charterparty. His reasons for rejecting the implication were "because the omission of an express warranty may well have been deliberate, because such an implied term is not necessary for the business efficacy of the charter and because such an implied term would at best lie uneasily beside the express terms of the charter."

21. In my judgment, the judicial observations so far considered represent a clear, consistent and principled approach. It could be dangerous to reformulate the principles, but I would add six comments on the summary given by Lord Simon in the BP Refinery case as extended by Bingham MR in the Philips case and exemplified in The APJ Priti. First, in Equitable Life Assurance Society v Hyman [2002] 1 AC 408, 459, Lord Steyn rightly observed that the implication of a term was "not critically dependent on proof of an actual intention of the parties" when negotiating the contract. If one approaches the question by reference to what the parties would have agreed, one is not strictly concerned with the hypothetical answer of the actual parties, but with that of notional reasonable people in the position of the parties at the time at which they were contracting. Secondly, a term should not be implied into a detailed commercial contract merely because it appears fair or merely because one considers that the parties would have agreed it if it had been suggested to them. Those are necessary but not sufficient grounds for including a term. However, and thirdly, it is questionable whether Lord Simon's first requirement, reasonableness and equitableness, will usually, if ever, add anything: if a term satisfies the other requirements, it is hard to think that it would not be reasonable and equitable. Fourthly, as Lord Hoffmann I think suggested in Attorney General of Belize v Belize Telecom Ltd [2009] 1 WLR 1988, para 27, although Lord Simon's requirements are otherwise cumulative, I would accept that business necessity and obviousness, his second and third requirements, can be alternatives in the sense that only one of them needs to be satisfied, although I suspect that in practice it would be a rare case where only one of those two requirements would be satisfied. Fifthly, if one approaches the issue by reference to the officious bystander, it is "vital to formulate the question to be posed by [him] with the utmost care", to quote from *Lewison, The Interpretation of Contracts* 5th ed (2011), p 300, para 6.09. Sixthly, necessity for business efficacy involves a value judgment. It is rightly common ground on this appeal that the

> test is not one of "absolute necessity", not least because the necessity is judged by reference to business efficacy. It may well be that a more helpful way of putting Lord Simon's second requirement is, as suggested by Lord Sumption JSC in argument, that a term can only be implied if, without the term, the contract would lack commercial or practical coherence."

65. Lord Neuberger also emphasised (at para 24) that the decision of the Privy Council in Belize Telecom had not diluted the requirements that must be satisfied before a term will be implied.

66. Lord Neuberger then went on to consider (at paras 25-28) the relationship between the processes of interpretation and implication of terms. In a passage with which the majority of the Supreme Court agreed (but with which Lord Carnwath did not agree) Lord Neuberger said,

> "27. Of course, it is fair to say that the factors to be taken into account on an issue of construction, namely the words used in the contract, the surrounding circumstances known to both parties at the time of the contract, commercial common sense, and the reasonable reader or reasonable parties, are also taken into account on an issue of implication. However, that does not mean that the exercise of implication should be properly classified as part of the exercise of interpretation, let alone that it should be carried out at the same time as interpretation. When one is implying a term or a phrase, one is not construing words, as the words to be implied are *ex hypothesi* not there to be construed; and to speak of construing the contract as a whole, including the implied terms, is not helpful, not least because it begs the question as to what construction actually means in this context.
>
> 28. In most, possibly all, disputes about whether a term should be implied into a contract, it is only after the process of construing the express words is complete that the issue of an implied term falls to be considered. Until one has decided what the parties have expressly agreed, it is difficult to see how one can set about deciding whether a term should be implied and if so what term. This appeal is just such a case. Further, given that it is a cardinal rule that no term can be implied into a contract if it contradicts an express term, it would seem logically to follow that, until the express terms of a contract have been construed, it is, at least normally, not sensibly possible to decide whether a further term should be implied. Having said that, I accept Lord Carnwath JSC's point in para 71 to the extent that in some cases it could conceivably be appropriate to reconsider the interpretation of the express terms of a contract once one has decided whether to imply a term, but, even if that is right, it does not alter the fact that the express terms of a contract must

> be interpreted before one can consider any question of implication."

67. I think that Lord Neuberger's analysis of the distinction between interpretation and implication was directed at the more usual role of a court in interpreting the express terms of a contract in order to resolve ambiguities and reconcile inconsistencies between those express terms. That appears from his repeated reference to interpretation of the express terms of the contract and his subsequent endorsement (in paragraph 29 of his judgment) of Bingham MR's comment in the Philips case at 481,

> "The courts' usual role in contractual interpretation is, by resolving ambiguities or reconciling apparent inconsistencies, to attribute the true meaning to the language in which the parties themselves have expressed their contract. The implication of contract terms involves a different and altogether more ambitious undertaking: the interpolation of terms to deal with matters for which, *ex hypothesi*, the parties themselves have made no provision. It is because the implication of terms is so potentially intrusive that the law imposes strict constraints on the exercise of this extraordinary power."

For my part, I do not read Lord Neuberger as intending to overrule the line of cases on correction of mistakes by construction or to subsume them in the process of implication of terms.

68. In my judgment, what these authorities show is that there may be cases in which an analysis of the express terms of a contract leads to a clear conclusion that something is missing, and in such a case the court may be able to supply the missing words or terms. Whether that result is characterised as the process of correction of mistakes by construction referred to in Chartbrook, or as the process of implication of terms addressed in M&S v BNP may be open to debate, but there are certain features common to both lines of authority. On either view, the test that must be satisfied to justify such a result is a strict one. 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 is 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.

69. In the instant case, I consider that there is considerable force in Mr. Goldring's points that the definitions of Senior Rate and Junior Rate are not mere boilerplate, but carefully constructed and central to the commercial deal being struck between the contracting parties to the Intercreditor Agreement. Accordingly, I accept that it would be reasonable to approach the issue on the basis that the relevant clauses and definitions of Senior Rate and Junior Rate in the Intercreditor Agreement are likely to have been paid some care and attention by the contracting parties: this is an example of the point made by Lord Neuberger in paras 17 and 18 of Arnold v Britton.

70. I also think that Mr. Goldring is right, first, that it is inherent in the nature of a Mortgage Loan, and would have been manifestly foreseeable by the parties at the time of execution of the Intercreditor Agreement, that the Nordostpark Borrower might fail to repay the Nordostpark Mortgage Loan at maturity and that the Swap Agreement would then expire, leaving the Nordostpark Borrower liable to pay Default Interest. Secondly, it is also the case that the express terms of clause 13.4.2 of the Intercreditor Agreement envisaged that the Swap Agreement might be terminated during the period of the Facility Agreement, either following an Event of Default or following the early repayment of any part of the Mortgage Loan. Mr. Goldring therefore submitted, and I again accept, that there is no obvious basis upon which the court could conclude that the contracting parties to the Intercreditor Agreement might simply have failed to foresee the type of situation which has arisen in which the Nordostpark Borrower might still be obliged to pay a Fixed Rate of interest on the Mortgage Loan, but in which the Swap Agreement would not be in place.

71. For the reasons identified by Lord Hoffmann in Chartbrook ("we do not readily accept that people have made mistakes in formal documents") and by Bingham MR in the passages from his judgment in Philips to which Lord Neuberger referred in paragraph 19 of his judgment in M&S v BNP, these points make it very difficult for the court to be confident that the absence of additional wording altering the definitions of Senior Rate and Junior Rate in the event that the Swap Agreement was no longer in place was the result of oversight or mistake.

72. Adding the words, "or (where no Hedging Agreement remains in place) the Fixed Rate", to limb (b) of the definitions of Senior Rate and Junior Rate might go some way to bringing the basis for the operation of clauses 12.3.2 or 17.1.3 into line with the receipt and retention by the Lenders of Fixed Rate interest where the Swap Agreement was no longer in force. But it would not create an exact match in any event due to the need to provide for costs etc, and nor would it cater for all other possibilities. That much is apparent from the fact that Hayfin has thought it desirable to advance a further alternative to be added to the definitions of Senior Rate and Junior Rate, namely,

> "or (following an Event of Default where no Hedging Arrangement remains in place), the higher of EURIBOR and the Fixed Rate."

73. As I understand it, the additional reference to "the higher of EURIBOR and the Fixed Rate" proposed by Hayfin is intended to address the possibility that after an Event of Default the Borrower might be required to pay Default Interest under clause 8.3 of the Facility Agreement. That clause is set out in paragraph 15 above and in essence provides for the payment of Default Interest at one per cent over the higher of EURIBOR and the Fixed Rate, together in each case with the fixed Margin and Mandatory Costs (if any). However, under clause 8.3 the trigger for the payment of Default Interest is not an Event of Default, but failure to pay an amount under a Finance Document on the due date which has not been remedied. Whilst that might constitute an Event of Default under clause 23.1 of the Facility Agreement, it is not automatically so; it would not do so if caused by administrative or technical error and cured within three Business Days. There are, moreover, other Events of Default in clause 23 of the Facility Agreement that would not trigger the payment of Default Interest by the Borrower under clause 8.3. Hayfin's suggested additional wording

therefore does not seem to match the circumstances in which Default Interest might be payable by the Nordostpark Borrower. Further, Default Interest is to be compounded – something that is also not catered for in Hayfin's additional wording.

74. The fact that Hayfin's additional wording does not precisely address the problem that it contends exists with the express wording of the Intercreditor Agreement is also apparent on an examination of the hypothetical worked examples produced by Hayfin to which I have referred above. These were produced to illustrate the contention that, in certain scenarios involving the absence of the Swap Agreement, but simplified so as not to take into account costs and the compounding of Default Interest, the express wording of the Senior Rate and Junior Rate definitions would result in monies paid by the Nordostpark Borrower or realised from enforcement of the Security being unallocated by the Intercreditor Agreement. But re-running those scenarios using the additional words proposed by Hayfin did not actually eliminate the surplus in every case.

75. Accordingly, I do not think that Hayfin's proposed wording clearly or even accurately cures the problem which it says is caused by the express words of the Intercreditor Agreement. Taken together with the further point made by Mr. Goldring that it is by no means obvious that the particular scenarios and assumptions used (including the very low EURIBOR rate) would be likely to have occurred to the parties when the Intercreditor Agreement was being drafted in 2006, I think that this makes it impossible to reach a clear conclusion that the parties would, if asked at the time of contract, have adopted the additional wording suggested by Hayfin. On the authorities referred to above, that uncertainty must be fatal to the contention that the alleged mistake can be corrected by construction or that Hayfin's additional wording can be implied.

76. I should deal with two further points made by the parties in relation to the first issue. First, I have focussed above on clause 12.3.2 as the relevant clause providing for the application of monies received from the Nordostpark Borrower in payment to the Issuer and Junior Lenders at a time when there is no continuing Event of Default; and on clause 17 as providing the post-default waterfall to apply whilst an Event of Default had occurred and is continuing. However, Mr. Pascoe placed considerable reliance upon clause 13.1 of the Intercreditor Agreement in support of Hayfin's contention that it was an essential part of the bargain encapsulated in the Intercreditor Agreement that all of the Fixed Rate interest payable by the Nordostpark Borrower in any Interest Period should be utilised in making payments to the Issuer and the Junior Lenders.

77. Clause 13.1 provides,

> "13.1 Junior Rates
>
> The parties agree that interest payable by the Borrower under the Facility Agreement under Clauses 8.1 (*Calculation of Interest*), 8.2 (*Payment of Interest*) and 8.3 (*Default Interest*) thereof shall be apportioned between the Lenders as follows:
>
> 13.1.1 by the application of the Senior Rate to the amount of the Senior Loan then outstanding; and

> 13.1.2 by the application of the relevant Junior Rate to the amount of the relevant Junior Loan then outstanding,
>
> in each case including the Default Interest rate set out in the Facility Agreement where applicable."

78. I find clause 13.1 a difficult clause to reconcile with the remainder of the Intercreditor Agreement. Quite apart from the oddity of the title to the clause, it is not obvious to me (and I do not think either party satisfactorily explained) precisely when or how this clause is intended to operate, what function it serves, and how, (if at all) it relates either to clause 12.3.2 or clause 17.

79. For example, clause 13.1 does not seem to take into account the possibility that if no Event of Default is continuing, any interest payable by the Borrower is required to be paid into the Tranching Account pursuant to clause 12.2.1 and then would be required to be applied first in payment of unpaid fees, costs and expenses (including in particular in making any payments required under the Swap Agreement) under clauses 12.3.1 before the resulting monies are applied in making any payments of interest to the Issuer and Junior Lender under clause 12.3.2. It may be, however, that the reference to "apportionment" signifies that clause 13.1 is simply intended to set out the relative proportions in which the Senior Loan and the Junior Loan qualify for payments of interest so as to make provision, for example, for the situation that would arise if the amounts received from the Nordostpark Borrower were insufficient to pay all interest due on the Senior Loan and the Junior Loan in full under clause 12.3.2.

80. Of more significance in the current circumstances, however, I do not see how clause 13.1 can be intended to operate according to its terms if an Event of Default has occurred and is continuing. In that situation, I think that it is apparent that clause 17 is the provision that expressly applies and provides that all monies received from the Nordostpark Borrower will be applied in accordance with the post-default waterfall. That waterfall does not provide for the "apportionment" of interest payable by the Nordostpark Borrower between payments of interest to the Issuer and the Junior Lenders, but subordinates payment of any interest to the Junior Lenders behind payment of interest <u>and principal</u> to the Issuer. It also subordinates any payment of Default Interest behind all such payments, rather than "including" it in any apportionment as suggested by the last phrase of clause 13.1.

81. Mr. Pascoe suggested that the fact that clause 13.1 refers to Default Interest must mean that the clause was expected to operate after an Event of Default. That is not so, because Default Interest is payable under clause 8.3 of the Facility Agreement on any late payments, but late payment does not automatically result in an Event of Default (see paragraph 73 above). But in any event I do not see how the passing reference to Default Interest in clause 13.1 can mean that the provisions of clause 13.1 displace the express provisions of the clause 17 post-default waterfall if there is a continuing Event of Default.

82. Accordingly, I simply do not think that clause 13.1 is capable of supporting the weight that Mr. Pascoe placed upon it in contending for the additional words to be added to the definitions of Senior Rate and Junior Rate.

83. The second point is Mr. Goldring's suggested answer to the possibility of unallocated monies being left in the structure at the end of the day because of the disparity between the Fixed Rate of interest payable by the Borrower and EURIBOR. In that event, Mr. Goldring submitted that the parties could utilise clause 3.5 of the Intercreditor Agreement which provides,

> "The Agent may act on the instructions of the Majority Senior Lenders in the exercise of any right, power or discretion not expressly provided for in the Finance Documents and this Deed. Any such instructions will be binding on all the Lenders. In the absence of any such instructions, the Agent may act as it considers to be in the best interest of the Lenders."

84. I accept that the wording of this clause would authorise the Agent to act on instructions by the Majority Senior Lenders as to how to deal with any surplus monies, or would enable it to decide how to do so itself in the interests of all of the Lenders. Though this clause is rather general in nature, in my judgment it is preferable to rely upon a clause that the parties chose to put into the agreement to deal with unforeseen events, rather than rely upon the alternative suggested by Hayfin. That would involve refashioning the Intercreditor Agreement with the benefit of hindsight of the unexpectedly low levels of EURIBOR, by adding words to the agreement in circumstances in which the contracting parties themselves appear to have chosen not to do so. As Bingham MR remarked in Philips, such an invitation is tempting, but to accept it would be wrong, because it is not what the parties agreed.

Issue 1(2): Default Interest

85. The second part of the first issue to be decided is,

> "Whether, as a matter of construction, for the purpose of calculating the Expected Available Interest Collections in respect of the Nordostpark Mortgage Loan for the January 2015 Payment Date (and accordingly for the purpose of determining the amount of interest due and payable on the Class X Note), and whether or not the Claimants are correct on Issue 1(1), the interest payable to the Senior Lender in respect of the Nordostpark Mortgage Loan should have included Default Interest payable by the Nordostpark Borrower at the rate of 1% per annum."

86. Mr. Pascoe submitted that, whether or not Hayfin is correct in relation to Issue 1(1), the Issuer's calculations of interest due and payable on the Class X Note were wrong for a separate reason, namely the failure to take into account Default Interest payable by the Nordostpark Borrower in accordance with clause 8.3 of the Facility Agreement. Mr. Pascoe submitted that since the Nordostpark Borrower failed to repay the Nordostpark Mortgage Loan on maturity in 2012, it was liable to pay Default Interest, and that this should have been assumed to have been paid in full and included in the calculation of Expected Available Interest Collections and thus in the calculation of the Class X Interest Amount.

87. I accept that the definition of Expected Available Interest Collections requires it to be assumed that the Nordostpark Borrower had paid Default Interest due on the Nordostpark Mortgage Loan in full on the relevant Payment Date in accordance with the Facility Agreement. However, as Mr. Goldring submitted, the related definition of Available Interest Collections makes it clear that it is still necessary to ask whether any such monies notionally paid would or would not have been transferred into the Issuer's Transaction Account (thereby becoming available to the Issuer).

88. In that regard, as indicated above, it is clear that if an Event of Default is continuing, all Default Interest payable by the Nordostpark Borrower under clause 8.3 of the Facility Agreement would fall to be applied by the Agent in accordance with the post-default waterfall in clause 17 of the Intercreditor Agreement. As I see it, the clear intention and effect of clauses 17.1.3 and 17.1.12 of that waterfall is to subordinate the payment of Default Interest to the Issuer until after any unpaid interest and principal has been paid to the Issuer and to the Junior Lenders. Accordingly, even if the Nordostpark Borrower is assumed to have paid Default Interest in full, whilst an Event of Default is continuing, none of that money would be transferred into the Issuer's Transaction Account by way of payment of Default Interest unless and until the prior-ranking items in clauses 17.1.1 to 17.1.11 inclusive of the post-default waterfall had been paid in full.

89. Mr. Pascoe submitted that this interpretation of clause 17 of the Intercreditor Agreement is untenable because it illegitimately seeks to recharacterise the sums payable by the Nordostpark Borrower in respect of interest as having been paid in respect of principal. He suggests that the definition of "Borrower Interest Collections" appears to depend upon whether the payments made by the Nordostpark Borrower are in respect of interest or principal, so that when making the assumption of full payment of such amounts required by the definition of Expected Available Interest Collections, the assumed payments will necessarily qualify as Borrower Interest Collections. He then submits that having so qualified, any subsequent transfer of such funds to the Issuer's Transaction Account will satisfy the definition of Available Interest Collections, irrespective of whether, as between the Issuer and the Junior Lenders, the monies would be regarded as having been applied to pay interest or principal under the post-default waterfall in clause 17.

90. I do not accept that argument. The Conditions of the Notes make a clear distinction between (on the one hand) the application of the Available Interest Collections in payment, in order of priority of a sequence of payments defined as the "Issuer Revenue Pre-Enforcement Priority of Payments" and (on the other hand) the application of "Available Principal Collections" in payment, in order of priority of a sequence of payments defined as the "Issuer Principal Pre-Enforcement Priority of Payments". The entitlement of the Class X Note to payment of the Class X Interest Amount falls (unsurprisingly) under the Issuer Revenue Pre-Enforcement Priority of Payments sequence. It seems to me that it is inherent in this basic structure that it is the nature of the monies received, as seen from the perspective of the Issuer, that will determine whether they fall to be treated as available to pay interest or repay principal on the Notes.

91. As such, I conclude that if, under clause 17 of the Intercreditor Agreement, Default Interest which would be payable by the Borrower after an Event of Default under clause 8.3 of the Facility Agreement would be applied in payment of principal due but

unpaid on the Senior Loan or the Junior Loan rather than in payment of Default Interest to the Issuer or the Junior Lenders, then such monies will not qualify as Expected Available Interest Collections.

Issue 2: Servicing Fees

92. The second issue to be decided is

> "Whether, as a matter of construction, for the purpose of determining the amount of interest due and payable on the Class X Note for the January 2015 Payment Date, the payment of servicing fees under Clause 17 of the Nordostpark Intercreditor Agreement reduced, to the extent of such fees, the amount of Expected Available Interest Collections for the January 2015 Payment Date."

93. I did not receive any detailed submissions on this issue, because both parties appeared to accept, as I think is right, that whatever reasoning applied to Issues 1(1) and 1(2) would also dictate the answer to this question.

94. In my view, for the reasons given above, even on the assumption that the Nordostpark Borrower made full and timely payment of all amounts of interest due from it under the Facility Agreement for the relevant Interest Period as required by the definition of Expected Available Interest Collections, if an Event of Default has occurred and is continuing, clause 17 of the Intercreditor Agreement will be operable, so that any such payments received would be applied under clause 17.1.1, "first, in or towards any fees, costs and expenses of the Agent and any receiver which are then due and payable under the Finance Documents including any fees, costs or expenses of the Servicer and/or the Special Servicer".

95. The amount of any monies which would thereafter be available to be paid into the Transaction Account of the Issuer under any of the subsequent items of the post-default waterfall would therefore be reduced by the prior payment of the extent of such fees, costs and expenses. Since the amount of the Available Interest Collections depends upon the amounts that are transferred into the Issuer's Transaction Account, the amount of the Expected Available Interest Collections would be correspondingly reduced.

Issue 3: Class X interest payable on the January 2015 Payment Date

96. The third issue to be determined is, whether, in the light of the answers to issues 1 and 2, Hayfin's calculation of the Class X Interest Amount payable on the January 2015 Payment Date is correct. Since I have found against Hayfin on Issues 1 and 2, the answer to Issue 3 must be "No".

Issue 4: The effect of capitalisation of interest on the Adductor Mortgage Loan

97. The fourth issue to be decided is,

> "Whether, as a matter of construction, for the purpose of determining the amount of interest due and payable on the

> Class X Note for the October 2015 Payment Date, the capitalisation of unpaid interest on the Adductor Mortgage Loan had the effect of reducing, to the extent of that capitalisation, the Expected Available Interest Collections for the purpose of calculating the Class X Interest Amount for the October 2015 Payment Date."

98. As I have indicated, the background to this Issue is that in the third quarter of 2015, €1,843,644.10 of unpaid interest in respect of the Adductor Mortgage Loan was capitalised in accordance with clause 22.3 of the Adductor Mortgage Loan Agreement. Thereafter, this amount was not included by the Issuer in the cumulative interest due and unpaid on the October 2015 Interest Payment Date, with the result that no Class X Interest Amount was paid on the October 2015 Interest Payment Date.

99. As translated from the original agreement (which was in French), clause 22.3 of the Adductor Mortgage Loan Agreement provided as follows:

> "22.3 Due date of default interest
>
> Any interest accruing under the provisions of Article 22.2 (*Default Interest*) on an Unpaid Amount shall be due and must be paid by the Borrower concerned at the end of the period for which it is calculated or any other date the Agent indicates in writing to the Borrower. Said interest (if unpaid) will be capitalised with the Unpaid Amount, only if, in accordance with Article 1154 of the Civil Code, said interest shall be due for a period of at least one year."

100. The translation of Article 1154 of the French Civil Code is as follows:

> "Interest due on capital may produce interest, either by a judicial claim, or by a special agreement, provided that, either in the claim, or in the agreement, the interest concerned be owed at least for one whole year."

101. The agreed issue that I have to decide does not include the question (which Hayfin was anxious to raise) whether such capitalisation had been properly carried out by the Issuer or the Special Servicer on the facts. I am simply asked to decide, as a matter of construction, what the effect of such capitalisation should have been upon the calculation of the Expected Available Interest Collections (and thus the Class X Interest Amount) for the October 2015 Payment Date.

102. Mr. Pascoe submitted that the capitalisation of unpaid interest on an underlying Mortgage Loan could not have been intended to affect adversely the holder of the Class X Note as regards payment of Class X interest. He submitted that the obvious purpose of the assumption required to be made in the definition of Expected Available Interest Collections, together with the availability of a Liquidity Facility to meet shortfalls in any monies actually received by the Issuer, was to protect the Class X Note against any failure by Borrowers to pay interest on Mortgage Loans when due. To buttress that submission, Mr. Pascoe drew attention to the fact that the risk factors in the offering circular in relation to the Class X Note made no mention of the

possibility that the Class X Interest Amount might be affected by any capitalisation of interest owing on an underlying Mortgage Loan.

103. As a preliminary observation, I note that both parties approached this issue on the basis that the correct interpretation of Expected Available Interest Collections is based upon the cumulative amount of Available Interest Collections that would have been available, assuming full and timely payment by the Adductor Mortgage Borrower of interest due on the Adductor Mortgage Loan on the October 2015 Payment Date. Since neither party contended to the contrary, I am content to assume that this is the case for the purpose of answering the issue raised.

104. I would, however, observe that I think that there is a tenable argument to the effect that if the assumption required for the computation of Expected Available Interest Collections is that the Borrower makes full and timely payment of interest on the relevant Payment Date, the Class X Note should only benefit from that assumption once in relation to the interest payable in any particular Interest Period. In other words, once the assumption is made that payment of the interest due on a Payment Date (Q1) is made on a full and timely basis, I am unclear why it should be assumed for the next Payment Date (Q2) that the same interest had not been paid and was still outstanding, so that it would be added to the further interest accruing due on the next Payment Date (Q2). Adopting a non-cumulative approach would still ensure that the Class X Noteholder was insulated against any failure by the Borrower to pay interest when due: but it would not mean that it derived a cumulative benefit from continued non-payment. Moreover, if this approach were adopted, the question of capitalisation of unpaid interest would never result in a reduction of the Expected Available Interest Collections, but could only benefit the Class X Noteholder by ensuring that interest could be charged on the increased principal outstanding in the subsequent Interest Periods.

105. That said, on the basis of a cumulative approach, I think that the Issuer was correct to reduce the amount of the Expected Available Interest Collections to take account of the capitalisation of interest. The simple reason is that the ability to capitalise unpaid interest after one year was identified and built into the Adductor Mortgage Loan Agreement, and the Noteholders must therefore have envisaged that such power was available to be utilised if and to the extent that the servicer considered that to do so was consistent with its duties to manage the Issuer's assets in accordance with the "Servicing Standard". The natural and obvious effect of capitalisation of unpaid interest would be to reduce the amount of unpaid interest owing by the Borrower, and, by capitalisation, to enable the Issuer in effect to charge compound interest on that unpaid amount thereafter. If it had been intended that such capitalisation should not have the result of reducing the amount of the Expected Available Interest Collections, or that the computation of such amount should disregard any capitalisation of interest, that could and should have been spelt out in the documents. It was not.

106. Further, on the cumulative basis of computation, the anticipated effect of the operation of clause 22.3 of the Adductor Mortgage Loan Agreement and Article 1154 of the French Civil Code as suggested by the Issuer would be that the amount of the Expected Available Interest Collections would steadily increase if interest remained unpaid by the Borrower, but would then in effect stabilise after a year. That is because, in each successive Interest Period, unpaid interest for the Interest Period a year earlier could be capitalised, and the new interest for the current Interest Period

would fall due for payment. Contrary to Mr. Pascoe's submissions, I do not see how that would "fail to protect" the Class X Noteholders from a default in the payment of interest by the Borrower or otherwise be contrary to their contractual expectations. It would simply result in a natural limit upon the enhancement of their benefits, because in each successive Interest Period in which interest remained unpaid, the Class X Noteholders would benefit from an assumption that the Borrower had paid the whole of the interest due in the preceding year.

Issue 6: Interest on unpaid Class X interest

107. The sixth issue to be decided is,

> "Whether, as a matter of construction, any amounts of historic unpaid Class X interest accrue interest at the Class X Interest Rate or at some other and (if so) what rate until payment; or whether no such interest accrues."

108. As indicated above, this issue only arises in the event that (contrary to the view that I have taken above) there has been a historic underpayment of Class X interest. Although I have decided that there has been no such underpayment, the parties were keen that I should express a view on the point.

109. For Hayfin, Mr. Pascoe relied on Condition 5(i) of the Notes to submit that any amounts of historically underpaid Class X Interest Rate would accrue interest, at the Class X Interest Rate, until payment.

110. For the Issuer, Mr. Goldring first denied that any under-calculation of the Class X Interest Amount could ever trigger the contractual provisions for payment of interest in Condition 5(i). Secondly, Mr. Goldring contended that if Condition 5(i) was otherwise potentially applicable, the parties could not have intended the Class X Interest Rate should be applied to any unpaid amounts, because the very large numerical value of the Class X Interest Rate would not give an appropriate level of compensation to the holder of the Class X Note for loss of use of money, but would give an absurdly high result. He submitted that the court should therefore interpret Condition 5(i) as requiring interest in respect of any unpaid Class X Interest Amounts only to be payable at a reasonable rate equivalent to the rates payable on the Regular Notes at the relevant time.

111. As a final alternative contention, Mr. Goldring submitted that because Hayfin's construction of Condition 5(i) would be likely to provide for payment of very large sums of money as a consequence of non-payment of amounts due on the Class X Note, if Condition 5(i) meant what Hayfin contended it meant, it would be void and unenforceable as a penalty at common law.

112. Condition 5(i) of the Notes is entitled "Deferral of interest" and provides that:

> "Subject to the provisions of this Condition 5(i) … if there is a shortfall in the required amount of Available Interest Collections on any Payment Date (after, for the avoidance of doubt, the drawing of any amounts available to the Issuer pursuant to the terms of the Liquidity Facility Agreement) then

> certain amounts of interest due on the Class B Notes, the Class C Notes, the Class D Notes, the Class E Notes, the Class F Notes and/or the Class X Note (beginning with the Class X Note and thereafter most junior such class) on such Payment Date shall be deferred (with the Issuer creating a provision in its accounts on such Payment Date equal to such interest deferred) and such interest shall not be due and payable until the next Payment Date on which the Issuer has sufficient Available Interest Collections to pay such amounts…
>
> Subject to the provisions of this Condition 5(i) … in the event that, on any Payment Date, Available Interest Collections, after deducting all amounts payable in priority to (i) (in the case of the Class X Notes) interest on the Class X Notes [and the Class B-F Notes] … is not sufficient to satisfy in full the aggregate amount due in respect of interest … the Issuer shall create a provision in its accounts for the shortfall … (the "Shortfall"). Such Shortfall shall itself accrue interest during the period from (and including) the due date therefor to (and excluding) the Payment Date upon which such Shortfall is paid at the same rate as that payable in respect of the relevant Class of Notes and shall be payable together with such accrued interest on any succeeding Payment Date only if and to the extent that on such Payment Date the relevant Available Interest Collections is sufficient to make such payment."

113. Hayfin's contention is that any failure to pay the correct Class X Interest Amount would give rise to a Shortfall as defined by Condition 5(i), and that this would itself accrue interest at the Class X Interest Rate applicable to the relevant Interest Period until payment, because that would be "the same rate as that payable in respect of the relevant Class of Notes".

114. Mr. Goldring's first line of defence to this argument was to rely upon Conditions 5(c) and (d) of the Notes. Condition 5(c) provides that:

> "…The rate of interest payable from time to time in respect of each Class of Notes … with respect to the Class X Note, the Class X Interest Rate (as defined below) … will be determined by the Agent Bank, as soon as practicable after 11:00 a.m. (Brussels time) on (i) in the case of the Regular Notes each Interest Rate Determination Date and (ii) in the case of the Class X Note, on each Determination Date..."

Condition 5(d) provides that:

> "…The Cash Manager will, on or as soon as practicable after each Determination Date, determine and notify the Issuer, the Trustee and the Paying Agents in writing of the Class X Interest Rate applicable to the Interest Period in which such Determination Date falls and the Class X Interest Amount (together with the Regular Note Interest Amount, the "Interest

> Amount") that will accrue on the Class X Note during that Interest Period…"

115. Mr. Goldring submitted that under these conditions, no monies were payable unless and until the Cash Manager had actually determined the Class X Interest Rate and the Class X Interest Amount. He then submitted that since (*ex hypothesi*) any such determinations would not have included any higher amounts now alleged to have been miscalculated, those higher amounts never in fact actually became due and payable. Hence, he submitted, there was no insufficiency in "the aggregate amount due in respect of interest" as required by Condition 5(i), which was therefore not engaged.

116. Secondly, Mr. Goldring submitted that Condition 5(i) was not designed to deal with miscalculations of the amounts of interest payable under the Notes in general terms, but was designed to deal specifically with a situation in which there was an identified shortfall in the amount of the Available Interest Collections (including drawings on the Liquidity Facility) to pay the amounts of interest due on the Notes in any Interest Period and to provide a contractual mechanism for how that should subsequently be addressed.

117. Although I confess that I was not immediately attracted to these arguments, on reflection, I think that they are correct. The Conditions provide an elaborate mechanism for the determination and publication of the amounts which will become due and payable on the Notes. Important consequences (such as the occurrence of Events of Default) attach to timely and precise compliance with payment obligations under the Notes, and hence it is consistent with the overall CMBS structure that the payment obligations of the Issuer in respect of the Notes should be defined by those determinations.

118. Further, Condition 5(i) is not a clause that provides generally for a contractual remedy for miscalculations and resultant underpayment of amounts due under the Notes. Instead it provides a specific mechanism to address the possibility that notwithstanding the availability of the Liquidity Facility, the Issuer might suffer a cash-flow shortage to meet its identified obligations under the Notes. In that event, Condition 5(i) provides for the deferral of the Issuer's obligations to make the payments that have been determined to be due to a subsequent Payment Date at which there are sufficient Available Interest Collections to make the payments, and it does so on terms that a stated rate of interest will accrue on the deferred amounts in the meantime. It also concludes that, "for the avoidance of doubt", any non-payment of an amount that might otherwise have become due shall not constitute a Note Event of Default.

119. In these circumstances, I do not accept that Hayfin can invoke Condition 5(i) according to its specific terms, or make good its argument that it provides generally for a contractual rate of interest to be applied to subsequently discovered under-declarations and underpayments of the Class X Interest Amount.

120. Mr. Goldring observed, and I agree, that this interpretation of Condition 5(i) would not leave a Class X Noteholder without any remedy in the event of a miscalculation and consequent underpayment of the amounts that ought to have been paid. The Note Trustee could, in the absence of agreement as to how to remedy the situation, and subject to the provisions for finality of such determinations and the general limitations

on recourse in the CMBS structure, bring proceedings for breach of contract under which it would be entitled to claim interest pursuant to statute to compensate Noteholders for being kept out of monies that should have been paid.

121. Although that conclusion is sufficient to dispose of Issue 6, I should briefly indicate my views on the two other points raised by Mr. Goldring.

122. As a preface to both points, I would reiterate that there is clearly a fundamental difference between the concept of the interest and interest rates payable on the Regular Notes (on the one hand), and the Class X Interest Amount and the Class X Interest Rate (on the other). The payment of interest on the Regular Notes is a payment of contractual interest on monies invested in the conventional sense, namely consideration payable for the use of monies borrowed at a stated rate by reference to the principal amount borrowed and the period of the loan: see e.g. Riches v Westminster Bank [1947] AC 390 at 400 per Lord Wright and Cairns v MacDiarmid [1982] STC 226 at 243 per Nourse J.

123. In contrast, although the CMBS documentation uses the word "interest" in relation to the Class X Note, it is clear that the Class X Interest Amount is not a payment of "interest" in any conventional sense of that word. The Class X Interest Amount bears no relation to the principal amount of the Class X Note but is simply derived from the excess monies expected to arise in the hands of the Issuer generated by the CMBS structure; and the Class X Interest Rate is simply an expression of the arithmetical relationship between the Class X Interest Amount and the principal value of the Class X Note at the Payment Date in question. For that reason, from the outset, the Class X Interest Rate (expressed quarterly) could be expected to vary considerably, and the Class X Interest Rate expressed at a particular Payment Date could not be expected to bear any relation to the Class X Interest Rate at any other Payment Date.

124. I also think that the clear expectation of the parties at the time of the contract must have been that the Class X Note would deliver a significant return to its holder, bearing in mind the very large amounts in play in the Windermere VII CMBS structure. This would also be consistent with the general understanding in the market referred to in the extract from *Peterson, Commercial Mortgage Loans and CMBS: Developments in the European Markets*, to which I have referred above, that class X notes could yield significant profits for arranging banks. The comparatively tiny principal value of the Class X Notes would thus almost inevitably result in the computation of a Class X Interest Rate significantly in excess of a normal commercial interest rate.

125. These expectations were borne out in practice: by way of example, the Class X Interest Rate was from the outset in 2006 between about 2,700% and 5,100% per quarter, only falling suddenly from 2,854% for the quarter ended 22 July 2008 to zero for three quarters, before rising again to 6,001% in the quarter ended 22 July 2009. Thereafter, apart from the last two quarters ending in October 2015 and January 2016 when it was zero, the Class X Interest Rate was regularly in excess of several thousand per cent each quarter. The lowest value of the Class X Interest Rate was 846% for the quarter ending in July 2014.

126. Against this background, Mr. Goldring submitted that the parties could not sensibly be taken to have intended that the Class X Interest Rate should be used to calculate

the amount of any interest that should accrue on any underpaid Class X Note Amount if (contrary to his primary argument) Condition 5(i) was applicable. He said that this would be an absurd result, which would grotesquely overcompensate the Class X Noteholder for loss of use of money, and that the court should imply a term to the effect that a reasonable rate of interest would be payable.

127. I agree that whereas it would be understandable for the parties to have intended that the conventional rate of interest applicable to calculate the interest due on the Regular Notes (EURIBOR plus the Relevant Margins) should also be applied to the under-paid amounts of interest, it would be quite another thing – and surprising in the extreme - for the parties to have intended the Class X Interest Rate (which is not a conventional rate of interest) to be used as if it were a conventional rate of interest and applied to any underpayments of the Class X Interest Amount to compensate the Class X Noteholder for loss of use of money.

128. There are, however, two very substantial difficulties in the way of Mr. Goldring's submission. The first is that Condition 5(i) refers, without differentiation, to the Regular Notes and the Class X Note, and the documentation is replete with references to "interest" accruing on the Class X Note at the Class X Interest Rate: see e.g. the terms of Condition 5(c) referred to above. Against that background, it is not at all easy to see why the ordinary and natural meaning of the relevant words of Condition 5(i), namely "shall accrue interest…at the same rate as that payable in respect of the relevant Class of Notes" should not be taken to be a clear reference to the Class X Interest Rate in respect of the Class X Note. In that regard I would refer to what Lord Neuberger said in the extract from Arnold v Britton set out in paragraph 39 above.

129. The second difficulty is that even if the court were to be of the view that it would be absurd to apply the Class X Interest Rate to underpayments of the Class X Interest Amount, it is not immediately obvious what rate the parties would have agreed should be applied. Would they have agreed, for example, that the rate should be the same rate as the next highest ranking Class of Notes, a blended average rate of the outstanding Regular Notes (which Mr. Goldring suggested), or some other "appropriate rate" (which Mr. Pascoe suggested should be 6%)? Although the law permits the implication of terms requiring, for example, the payment of a "reasonable" price, or the giving of a "reasonable" period of notice, or the exercise of "reasonable" care (see e.g the authorities collected in *Lewison, The Interpretation of Contracts*, 6th ed. Chapter 6, sections 16-19), I do not think that a term as to the payment of a "reasonable" interest rate would be appropriate or workable in the particular context of a listed CMBS note structure, where certainty and clarity is at a premium. Questions would undoubtedly arise, for example, as to who should make the determination and on what basis. In that regard I have already referred in paragraphs 37 to 40 above to the authorities on the need for clarity and certainty as to what the parties would have agreed for there to be the correction of mistakes by construction, or the implication of terms.

130. I therefore turn briefly to Mr. Goldring's last line of argument – namely that if (contrary to his earlier arguments), the underpayment of the Class X Interest Amount in any relevant Interest Period triggered an obligation under Condition 5(i) to pay interest at the Class X Interest Rate on the underpaid amount, that provision would be void as a penalty.

131. The most recent and detailed examination of the common law penalty doctrine is the decision of the Supreme Court in Cavendish Square Holdings v Makdessi [2015] 3 WLR 1373 ("Cavendish").

132. In that case, the Supreme Court affirmed that the penalty doctrine only applies to provisions of contracts that impose secondary obligations upon a party in the event of breach of his primary obligations under the contract. Lord Neuberger and Lord Sumption (with whom Lord Carnwath agreed), said,

> "12. In England, it has always been considered that a provision could not be a penalty unless it provided an exorbitant alternative to common law damages. This meant that it had to be a provision operating upon a breach of contract … As a matter of authority the question is settled in England by the decision of the House of Lords in Export Credits Guarantee Department v Universal Oil Products Co [1983] 1 WLR 399. Lord Roskill, with whom the rest of the committee agreed, said at p 403:
>
> > "[P]erhaps the main purpose, of the law relating to penalty clauses is to prevent a plaintiff recovering a sum of money in respect of a breach of contract committed by a defendant which bears little or no relationship to the loss actually suffered by the plaintiff as a result of the breach by the defendant. But it is not and never has been for the courts to relieve a party from the consequences of what may in the event prove to be an onerous or possibly even a commercially imprudent bargain."
>
> …
>
> 14. This means that in some cases the application of the penalty rule may depend on how the relevant obligation is framed in the instrument, i.e. whether as a conditional primary obligation or a secondary obligation providing a contractual alternative to damages at law. Thus, where a contract contains an obligation on one party to perform an act, and also provides that, if he does not perform it, he will pay the other party a specified sum of money, the obligation to pay the specified sum is a secondary obligation which is capable of being a penalty; but if the contract does not impose (expressly or impliedly) an obligation to perform the act, but simply provides that, if one party does not perform, he will pay the other party a specified sum, the obligation to pay the specified sum is a conditional primary obligation and cannot be a penalty."

133. In setting out the test that should be applied to determine the validity or otherwise of such clauses, Lord Neuberger and Lord Sumption stated, at paras 31-32,

> "31. …The real question when a contractual provision is challenged as a penalty is whether it is penal, not whether it is a pre-estimate of loss. These are not natural opposites or mutually exclusive categories. A damages clause may be neither or both. The fact that the clause is not a pre-estimate of loss does not therefore, at any rate without more, mean that it is penal. To describe it as a deterrent (or, to use the Latin equivalent, *in terrorem*) does not add anything. A deterrent provision in a contract is simply one species of provision designed to influence the conduct of the party potentially affected. It is no different in this respect from a contractual inducement. Neither is it inherently penal or contrary to the policy of the law. The question whether it is enforceable should depend on whether the means by which the contracting party's conduct is to be influenced are "unconscionable" or (which will usually amount to the same thing) "extravagant" by reference to some norm.
>
> 32. The true test is whether the impugned provision is a secondary obligation which imposes a detriment on the contract-breaker out of all proportion to any legitimate interest of the innocent party in the enforcement of the primary obligation. The innocent party can have no proper interest in simply punishing the defaulter. His interest is in performance or in some appropriate alternative to performance…"

134. To similar effect was Lord Mance at para 152,

> "…What is necessary in each case is to consider, first, whether any (and if so what) legitimate business interest is served and protected by the clause, and, second, whether, assuming such an interest to exist, the provision made for the interest is nevertheless in the circumstances extravagant, exorbitant or unconscionable. In judging what is extravagant, exorbitant or unconscionable, I consider (despite contrary expressions of view) that the extent to which the parties were negotiating at arm's length on the basis of legal advice and had every opportunity to appreciate what they were agreeing must at least be a relevant factor."

135. Likewise, Lord Hodge (with whom Lord Toulson agreed) said, at para 255,

> "I therefore conclude that the correct test for a penalty is whether the sum or remedy stipulated as a consequence of a breach of contract is exorbitant or unconscionable when regard is had to the innocent party's interest in the performance of the contract. Where the test is to be applied to a clause fixing the level of damages to be paid on breach, an extravagant disproportion between the stipulated sum and the highest level of damages that could possibly arise from the breach would amount to a penalty and thus be unenforceable. In other

> circumstances the contractual provision that applies on breach is measured against the interest of the innocent party which is protected by the contract and the court asks whether the remedy is exorbitant or unconscionable."

136. In the instant case, Mr. Goldring first asserted, and Mr. Pascoe did not dispute, that any interpretation of Condition 5(i) that provided for the accrual and payment of interest at the Class X Interest Rate in the event of an underpayment of the Class X Interest Amount could be regarded as a secondary obligation imposed upon a contract-breaker so as potentially to bring the penalty doctrine into play. For my part I am not sure whether that is necessarily correct: it seems to me to be arguable that if it applies at all, Condition 5(i) is drafted with the intention of deferring the Issuer's obligation to pay any amount until it has the available funds to do so. Whether the application of the Class X Interest Rate in such cases amounts to a conditional primary obligation or a secondary obligation as discussed in Cavendish at para 14 is, however, not a point upon which I heard any argument, and accordingly I do not express any view on it.

137. Assuming that the penalty doctrine would be applicable, both parties were in agreement that whether a contractual provision for the payment of interest in the event of a default in performance of a primary obligation to pay money is void or unenforceable as a penalty must be determined as at the date upon which the contract is entered into. There, however, the agreement between the parties ended.

138. Mr. Goldring contended that at the time of contract it could be foreseen that the Class X Interest Rate would have no relationship to the level of damage that would be suffered by the Class X Noteholder if the full Class X Interest Amount was not paid on the relevant Payment Date. He also contended that the parties would have expected the Class X Interest Amount to be substantial, so that it could have been foreseen that the application of the Class X Interest Rate to any Shortfall would produce a result that would be a very large multiple of the unpaid amount every quarter. He submitted that this would properly be described as an extravagant or exorbitant obligation to impose upon the Issuer out of all proportion to the legitimate interest of the Class X Noteholder in obtaining prompt payment. Mr. Goldring added, referring to Cooden Engineering v Stanford [1953] 1 QB 86, that a clause would not be saved from being penal simply because in an "exceptional and improbable" case the amount flowing from application of the prescribed formula might not exceed the loss flowing from the breach. Accordingly, so he submitted, whilst "in theory" the Class X Interest Amount for any Payment Date could have been less than €1,000 in an Interest Period so as to equate with a conventional market rate of interest, this remote possibility should not alter the penal nature of the clause.

139. Mr. Pascoe's answer was that there could be no disproportionate detriment to the Issuer in circumstances in which the Issuer was a special purpose vehicle that was only liable to make payments of interest and principal on the Notes on a limited recourse basis from sums paid to and proceeds recovered by or on behalf of the Issuer or the Note Trustee from the Mortgage Loans and the security provided for them (see Condition 17 of the Notes). He also disputed Mr. Goldring's suggestion that it would have been thought to be "exceptional and improbable" or "theoretical" that the Class X Interest Rate could turn out to be very small. Mr. Pascoe pointed to the fact that as events have turned out, the Class X Interest Amount was zero on three occasions in

October 2008-April 2009 and in the two most recent Interest Periods ending in October 2015 and January 2016.

140. Although I do not finally have to decide this point, I am inclined to think that Mr. Goldring is correct. If, contrary to the view that I have taken on the earlier questions, Condition 5(i) means that in the event of non-payment of the Class X Interest Amount on a Payment Date, further interest would accrue and be payable on that amount at the Class X Interest Rate, then for the reasons to which I have already alluded, the almost inevitable result that could be anticipated at the time of contract would be a multiplication of the unpaid amount by a very sizeable factor to arrive at a sum many times the amount that would adequately compensate the innocent party for being kept out of its money. 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).

141. Although Mr. Pascoe relied upon the fact that there had been a limited number of periods in which the Class X Interest Amount (and hence the Class X Interest Rate) was zero, I have no explanation as to why that was so, or whether the circumstances giving rise to it could have been anticipated. I do note, however, that the first three such periods commencing with the quarter ended 22 October 2008 corresponds with the unexpected (and wholly exceptional) collapse of the Lehman Brothers group (including LBIE which then held the Class X Note) into insolvency proceedings worldwide. At all other times apart from the last two quarters (which follow the disputed capitalisation of the interest on the Adductor Mortgage Loan which I have considered above) the Class X Interest Rate was regularly in excess of several thousand per cent each quarter.

142. I also do not think that the fact that the obligations of the Issuer are imposed on a limited recourse basis provides any exception or defence to the application of the penalty doctrine. As Lords Neuberger and Sumption indicated in Cavendish, the penalty doctrine does not depend upon whether it is subjectively intended to, or does, provide a deterrent to the particular contract-breaker, but must be founded upon objective reference to some norm. Accordingly, the penalty doctrine 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. Whether a clause is a penalty cannot therefore depend upon the ability of the particular contract-breaker to pay the specified amount, or the source from which he is to pay. An innocent party cannot save a clause from being a penalty by claiming that even though it provides for payment of a wholly disproportionate amount to the interest which he (the innocent party) has in performance, the contract-breaker is so rich that he will not notice the difference. Nor can he do so by promising to limit his claim to specified funds in the hands of the contract-breaker, if the available amount of those funds would still be capable of paying a wholly disproportionate amount, and payment might deprive the contract-breaker of the ability to pay debts due to other creditors with lower priority.

Issue 7: Underpayment and Events of Default

143. The last issue is whether, in light of the answers to Issues 1 to 6, there was an underpayment of the Class X Interest Amount for the Payment Dates in January 2015 and/or October 2015 and if so whether an Event of Default occurred thereby.

144. I have already decided that there has not been an underpayment of the Class X Interest Amount for the January 2015 and October 2015 Payment Dates, so that the answer to this issue is "No". Again, however, the parties addressed argument on the point of principle whether, if I was wrong in that view, any such underpayment would have been an Event of Default under the terms of the Notes, and they invited me to express a view upon the matter.

145. Mr. Pascoe submitted that any underpayment of the Class X Interest Amount for either of the January 2015 and October 2015 Payment Dates would have given rise to an Event of Default within the meaning of Condition 10(a)(i) of the Notes. That provides that there is an Event of Default upon:

> "the failure, for a period of three days, to make a payment of principal, or the failure, for a period of five days, to make a payment of interest on, the most Senior Class of Notes then outstanding; in each case when the same becomes due and payable in accordance with these Conditions".

146. Condition 10(a)(i) would not have been triggered in any event by any underpayment of the Class X Interest Amount in January 2015, since at that stage the Class X Note was not the most Senior Class of Notes then outstanding: that was the Class A2 Notes. It might, however, conceivably have been triggered at the October 2015 Payment Date, by which stage the Class A2 Notes had been repaid.

147. In that regard, Mr. Pascoe also contended that even though any underpayment of a Class X Interest Amount might not have been apparent at the October 2015 Payment Date, the period of five days had now expired, so that it would now be too late for any such Event of Default to be cured. Accordingly, he contended that under Condition 10(a) it would be open to the holders of 25% of the principal amount outstanding of the most senior class of Regular Notes to require a Note Enforcement Notice to be served by the Note Trustee. As I indicated at the start of this judgment, Hayfin has now acquired 34.34% of the principal amount outstanding of the Class B Notes, which would entitle it to require such Notice to be served. This would then accelerate the Notes and make the Security enforceable, and activate the "Post-Enforcement Priority of Payments" which would place the Class X Note at the top of the post-enforcement waterfall, followed by the Class B Notes.

148. I do not accept Mr. Pascoe's argument in this respect for much the same reasons that I explored in relation to Issue 6 concerning Condition 5(i). As I indicated there, I accept that the effect of Conditions 5(c) and 5(d) of the Notes was that the only Class X Interest Amounts that became due and payable on each Payment Date were those determined to be due and payable by the Cash Manager. Accordingly, as Mr. Goldring submitted, even if it might now be appreciated that there had been a miscalculation and underpayment of a Class X Interest Account for the October 2015 Payment Date, that would not have been an Event of Default in respect of the Notes.

149. Standing back, it seems to me that this is an entirely sensible commercial view of the Conditions, and that Hayfin's interpretation is without commercial merit. Given the hugely significant consequences for all parties of the occurrence of a Note Event of Default, I simply cannot see why, at the commencement of the CMBS structure, the parties should be taken to have intended to create what could amount to a concealed

"hair trigger", under which an Event of Default could accidentally occur because of a simple miscalculation of the amount of interest payable, without that fact being appreciated by anyone, and then be incapable of cure at a later date when it was discovered, no matter how solvent the structure might be.

Conclusion

150. For the reasons I have given, I do not consider that there has been an underpayment of the Class X Interest Amount for the January 2015 or October 2015 Payment Dates, or that any further interest at the Class X Interest Rate would have accrued thereon under Condition 5(i), or that any Note Event of Default has occurred as a consequence.

151. I shall ask counsel to agree a form of order containing declarations to give effect to the views that I have expressed.