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ARTICLE

Re Sigma Finance Corporation [2008] EWCA Civ 1303

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In *Re Sigma Finance Corporation* [2008] EWCA Civ 1303, the Court of Appeal was required to determine whether Mr Justice Sales had correctly construed clause 7.6 of the security trust deed (the 'Security Trust Deed') pursuant to which the assets of Sigma Finance Corporation ('Sigma') were secured for the benefit of the holders of loan notes issued by the company and held by the security trustee appointed (the 'Security Trustee'). The Security Trust Deed was governed by English law and contained a jurisdiction clause which had enabled proceedings to be commenced in England.

The issue, very broadly, was whether Sigma's secured liabilities were to be discharged as they fell due or on some other basis, in the period following enforcement by the Security Trustee but prior to distribution of the company's assets. Lord Justices Lloyd and Rimer affirmed the decision of Sales J and held that Sigma's secured liabilities were to be discharged as they fell due in that period. Lord Neuberger, sitting as a judge of the Court of Appeal, also rejected a construction requiring the discharge of such liabilities *pari passu* but, dissenting, considered that clause 7.6 accelerated those liabilities in part and required the receiver appointed to pay an amount he considered 'safe', having regard to the likely amount available for final distribution at the end of the realisation process.

This case note considers the causes of the disagreement between the appellate judges and two aspects of the case which may have wider implications for the construction of such security documents.

The facts

Sigma had carried on business as a structured investment vehicle which used short to medium term funding to acquire longer term and hopefully profitable asset-backed and other financial securities. Sigma's principal source of short to medium term funding was intermediated securities in the form of loan notes issued by the company and secured against the longer term assets acquired. The loan notes issued were held by the Security Trustee for the benefit of individual investors in accordance with the Security Trust Deed.

This investment structure relied on Sigma's continuing ability to repay, or rather to rollover, short to medium term funding. The structure failed when the market in asset-backed securities evaporated with the widening of the sub-prime mortgage crisis. Sigma was unable to repay existing liabilities through the issue of new loan notes, the sale of assets or other funding arrangements such as sale and repurchase transactions.

In these circumstances, the notice issued to the Security Trustee by a creditor providing a facility to Sigma constituted an enforcement event with an enforcement date effective from 2 October 2008. An immediate effect of enforcement was to trigger an asset realisation process which was to be completed within the prescribed 60 day realisation period ending on 29 November 2008 (the 'Realisation Period').

Clause 7.6 of the Security Trust Deed provided:

> '[1] The Security Trustee shall use its reasonable endeavours … to establish by the end of the Realisation Period a Short Term Pool, a number of Long Term Pools … and a Residual Equity Pool.
>
> [2] In order to establish such Pools, the Security Trustee shall during the Realisation Period (but not thereafter) realise, dispose of or otherwise deal with the Assets in such manner as, in its absolute discretion, it deems appropriate.
>
> [3] During the Realisation Period the Security Trustee shall so far as possible discharge on the due dates therefor any Short Term Liabilities falling due for payment during such period, using cash or other realisable or maturing Assets of the Issuer.'

The assets allocated to the various short and long term asset pools were to correspond to the various secured liabilities in terms of maturity, payment dates and currency of payment. The long term pools were, moreover, to comprise a pool in relation to each series of loan notes.

Notes

1 Simon Mortimore QC, Richard Sheldon QC, Felicity Toube and Daniel Bayfield were counsel for the representative creditors. Gabriel Moss QC and Barry Isaacs were counsel for the receivers.

The issue

The Security Trustee had appointed an administrative receiver (the 'Receiver'), and the issue was whether the third sentence of clause 7.6 above and, in particular, the words 'so far as possible' required the Receiver to discharge secured liabilities as they fell due in the Realisation Period, or to discharge such liabilities on some other basis, for example in accordance with the scheme of *pari passu* distribution ordinarily applicable in insolvency cases.

The issue was significant because payment of liabilities on a first-in-time basis would entirely exhaust the assets which would otherwise form the short term pool (and long term pools). The Receiver had, in particular, identified four classes of creditor affected:

(a) the holders of medium term notes maturing in the early part of the Realisation Period;

(b) the holders of medium term notes maturing in the later part of the Realisation Period;

(c) the holders of medium term notes maturing after the Realisation Period; and

(d) the holders of notes maturing more than 365 days after the effective enforcement date.

If the available assets were realised and used to discharge notes in class (a), no assets would be available for distribution to classes (b), (c) or (d), and so on. For this reason, a representative creditor was appointed in respect of each class, respectively Party A, B, C and D.

Party A submitted that the Security Trustee was to discharge secured liabilities as they fell due, day by day, until it had no more assets with which to do so (paragraph 35). Party B also contended a first-in-time rule was the correct priority rule but that it must be applied in respect of the class of secured liabilities falling due within the Realisation Period (paragraph 36). Parties C and D, by contrast, argued that discharge of the secured liabilities on a *pari passu* basis over the class of secured liabilities as a whole was the correct construction (paragraph 37).

In the course of argument, a further construction emerged in which the function of clause 7.6 was to accelerate part payment of the secured liabilities falling due within the Realisation Period and which would otherwise have to be paid under clause 7.11 at the end of that period (paragraph 122). On this view, the Security Trustee was to discharge such liabilities to the extent he judged it 'safe' to do so, having regard to the amount he anticipated would be available for distribution at the end of that period (paragraphs 115 and 119).

First-in-time priority

Parties C and D argued a first-in-time construction was contrary to business common sense because:

(1) the holders of loan notes all had essentially the same rights and its was 'pure chance' that the obligation to some matured within the Realisation Period (paragraph 42);

(2) further, having regard to the detailed mechanics of what constitutes an enforcement event, Sigma had some choice as to the effective enforcement date, and so the onset of the relevant period (paragraph 43);

(3) the scheme of distribution, as a whole, did not recognise any distinction amongst short term liabilities, or between short term and long term liabilities (paragraph 45); and

(4) if 'so far as possible' were to be construed to mean 'so far as the available assets allow', the words would have no content because they would add nothing to the words 'using cash or other realisable or maturing Assets of the Issuer' at the end of the third sentence (paragraph 55).

Lloyd and Rimer LJJ rejected these arguments because criticism of a first-in-time construction could not without more support a *pari passu* construction (paragraphs 58 and 87). Further, 'so far as possible' was not without content on Party A's construction as it protected the Security Trustee against any claim for breach of his obligations as trustee arising from a delay in payment due to the circumstances post enforcement (paragraph 56). Within the scheme of the Security Trust Deed, the *pari passu* rule was limited to distribution from each pool amongst the relevant class of liabilities in respect of that pool and had effect after the Realisation Period (paragraph 89).

Neuberger L similarly regarded a *pari passu* construction as unsustainable as a matter of language. A rateable distribution would be required whenever liabilities exceeded assets and, as such, 'so far as possible' would have to be construed to mean 'if possible' notwithstanding that the words naturally mean 'to the extent that' (paragraph 118).

Party B argued for a wider first-in-time rule on the basis that the words 'during such period' were without content on the narrow construction favoured by Party A, which required the Security Trustee to discharge maturing liabilities on a day-to-day basis (paragraph 47 and 73).

Lloyd and Rimer LJJ rejected Party B's argument because 'on the due dates therefor' indicated that liabilities maturing within the Realisation Period were to be paid on maturity, and 'so far as possible' could not, for the above reasons, be construed as requiring a *pari passu* discharge of short term liabilities within the Realisation Period (paragraphs 74 and 91).

Accelerated payment

Neuberger L favoured the fourth construction which emerged in the course of argument, which required

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the Security Trustee to discharge short term secured liabilities falling due within the Realisation Period to the extent it was 'safe' to do so having regard to the anticipated amount available for distribution at the end of that period.

He considered the submissions of Parties A and B to be 'unattractive in terms of business commonsense' principally because the Security Trustee would be required to carry out a 'fire-sale' in a weak market (paragraph 102). By contrast, he perceived no such problem in relation to the fourth solution, in which the Security Trustee was only 'to pay as much as he can be confident that the creditor concerned will receive if he had to wait for payment ... from the Short Term Pool at the end of the Realisation Period' (paragraph 111).

He also considered the fourth solution appropriate as a matter of language because to construe 'possible' as 'safe' was in line with the natural meaning of 'so far as possible' discussed above (paragraph 119), and the use of 'discharge' as opposed to 'pay' in clause 7.6 connoted part payment because other uses of 'pay' and 'payment' had been defined as 'redeem in full' (paragraph 120).

Lloyd LJ, with the agreement of Rimer LJ, rejected this construction because he considered 'discharge' to ordinarily mean 'paid in full' and found no indication that pro tanto discharge was the sense intended and, crucially, the Security Trustee Deed did not include any definition of the Security Trustee's obligation in relation to making an accelerated payment, or any protection in relation to the calculation of such a payment (paragraphs 64 and 65).

The construction favoured by Neuberger L is attractive because the obligations to discharge liabilities falling due within the Realisation Period and to make a distribution from the various pools formed at the end of that period each have a function notwithstanding the dramatic fall in the value of the secured assets. The fourth construction is nonetheless difficult to accept because the Security Trustee would have to participate in a distressed sale to some extent. In these circumstances, it is unlikely the parties intended a complex obligation to discharge certain liabilities in part. The obligation to pay secured liabilities as they fall due provides the Security Trustee with a complete defence to any potential claim because a 'fire-sale' is something the Security Trustee has to do to discharge his duty under the Security Trust Deed.

Analysis

The decision in *Re Sigma Finance Corporation* has no wider application. The issue was one of construction and, as highlighted above, can be explained as a straightforward application of the ordinary and well established principles of construction referred to in the judgments. The way in which those principles were in fact applied may however have some wider impact.

First, Lloyd and Rimer LJJ each had regard to the fact that the security documentation was extensive and was (probably) drafted by a team of commercial lawyers and, on this assumption, were inclined to reject any construction not apparent from the express language used (paragraphs 67, 86 and 87). This approach is difficult to accept. The identity of the draftsman leaves outstanding the question of construction and, as such, cannot properly be considered part of the 'relevant' contractual background (*BCCI v Ali* [2002] 1 AC 251, 296). The approach set out by Neuberger L at paragraphs 98 to 101 is the better approach. The majorities' reasoning is consistent with it, and their observations regarding the use of professional advisors merely reflect their conclusion that Parties B, C and D tried 'to load too much on too little' (paragraph 88).

Second, Lloyd LJ was inclined to treat the Security Trust Deed as a document akin to a constitutional document such as the memorandum and articles of association of a company because it 'affects the rights among themselves of a large number of people who are not parties to it' and he indicated that the implication of terms may not be possible for this reason (paragraph 38).

The soundness of this observation is open to doubt. First, the special approach to the construction of corporate constitutional documents flows from their public registration and the possibility that a third party may rely on them in their dealings with the company (*Scott v Frank F Scott (London) Ltd* [1940] Ch 794; *Bratton Seymour Service Co Ltd v Oxborough* [1992] BCLC 693).

Second, the majority did in fact imply a term in order to accommodate liabilities which had matured prior to the effective enforcement date. Lloyd LJ considered that 'one would naturally expect' such liabilities 'to be paid with at least as high a priority as any other liability' and construed clause 7.6 'to read the sentence as if it said "any Short-Term Liabilities already due or falling due for payment during such period"' (paragraphs 49 and 52). Rimer LJ similarly regard the failure to make express provision for such liabilities a 'mistake' and held that 'the only rational interpretation ... is that the pre-enforcement debts are to be treated as impliedly included within the class of liabilities referred to' (paragraphs 82 and 90).

Assessed in this light, it is readily apparent the implication of terms may be necessary however complex the underlying documents, and the possibility of such should only be excluded at the outset for very good reasons. That Parties B, C and D did not advance arguments for the implication of any term in their favour merely reflects the likelihood that any term in line with their submissions would not have been accepted as obvious or reasonably necessary for the working of the Security Trust Deed.

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International Corporate Rescue

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