International Corporate Rescue

Published by:
Chase Cambria Company (Publishing) Ltd
4 Winifred Close
Barnet, Arkley
Hertfordshire EN5 3LR
United Kingdom

Annual Subscriptions:
Subscription prices 2010 (6 issues)
Print or electronic access:
EUR 695.00 / USD 845.00 / GBP 495.00
VAT will be charged on online subscriptions.
For 'electronic and print' prices or prices for single issues, please contact our sales department at:
+ 44 (0) 207 014 3061 / +44 (0) 7977 003627 or sales@chasecambria.com

International Corporate Rescue is published bimonthly.

ISSN: 1572-4638

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ARTICLE

Re Sigma Finance Corporation (In Administrative Receivership) [2009] UKSC 2

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Following on from a previous case note in this publication which considered the Court of Appeal ruling, this article considers the recent decision of the Supreme Court in the Sigma litigation which was delivered on 29 October 2009 (*Re Sigma Finance Corporation (In Administrative Receivership)* [2009] UKSC 2). That decision was not only the first substantive decision of the new Supreme Court, but is to date the only occasion on which one of the numerous recent structured investment vehicle (or 'SIV') disputes has reached England's highest court.

This article considers the outcome of that final appeal, as well as the wider relevance of the Supreme Court's decision in the context of the other SIV disputes to date.

Recap of the facts

Sigma Finance Corporation ('Sigma') was a SIV incorporated under the law of the Cayman Islands, which was established to invest in certain types of asset-backed securities and other financial instruments. Sigma funded its activities largely by issuing its own shorter-term securities (principally, medium term notes) on the capital markets, and sought to profit from the spread between the return on its investments and its cost of funds. At its height, Sigma was the largest SIV in the market by value, with assets and liabilities understood to be in excess of USD 50 billion.

In 2007 and 2008, as is well known, the sub-prime mortgage crisis in the United States prompted market dislocation which severely impacted upon asset-backed securities and the vehicles which held them. These events had the combined effect of reducing the value of the securities held by Sigma in its investment portfolio and, at the same time, reducing the appetite among investors to acquire the notes which Sigma itself issued. This in turn limited Sigma's ability to fund its activities, and eventually precipitated an 'Enforcement Event' (as defined within Sigma's governing documentation) on 2 October 2008.

It is important to appreciate that the Enforcement Event did not render all of Sigma's secured obligations immediately due and payable – indeed the absence of such acceleration was an integral feature of the provisions at the heart of the dispute.

In effect, all of Sigma's assets were subject to a floating charge given under an English law Security Trust Deed dated 27 March 2003 (the 'Security Trust Deed') in favour of the Security Trustee (the 'Trustee') for the benefit of the secured creditors (which included holders of Sigma's medium term notes, its derivative counterparties and certain other classes of its creditors). The occurrence of the Enforcement Event on 2 October 2008 caused that floating charge to crystallise and constituted the 'Enforcement Date' for the purposes of the Security Trust Deed. On 6 October 2008, the Trustee appointed administrative receivers over Sigma's assets (the 'Receivers').

At the time of the Receivers' appointment, Sigma's liabilities to secured creditors were estimated at approximately USD 6.2 billion, and its liabilities to unsecured creditors a further approximately USD 3.6 billion. However, Sigma only held very limited assets by that point, and therefore had an insolvent deficit in excess of USD 9 billion in respect of all liabilities (secured and unsecured). On any analysis, there was a huge shortfall for the secured creditors.

The issue

Clause 7 of the Security Trust Deed provided a complex set of rules in respect of the distribution of Sigma's assets to secured creditors following the occurrence of an Enforcement Event. The dispute arose from an ambiguity within Clause 7 which, depending on the manner in which it was resolved, would have a far-reaching impact on the economic outcome for individual secured

Notes

1 Lovells LLP acts for the Receivers of Sigma Finance Corporation (In Receivership).

creditors. As with the other SIV disputes, creditors within the relevant constituencies took up the fight in favour of the competing construction most economically advantageous to them.

Clause 7 provided, in summary, that during the Realisation Period (which was a 60 day period commencing on the Enforcement Date), the Trustee was to use its reasonable endeavours to establish various separate pools of assets. Each pool was to be referable to a group of secured liabilities – one for secured liabilities falling due within 365 days of the Enforcement Date (the 'Short Term Pool' for 'Short Term Liabilities') and other pools for secured liabilities falling due further in the future (each being a 'Long Term Pool' for 'Long Term Liabilities'). It should be noted that the definition of Short Term Liabilities included those secured liabilities which fell due during the Realisation Period itself. The Security Trust Deed provided that if the assets were deemed to be inadequate, the shortfall was to be shared proportionally across the pools and that, once established, the assets in each pool were to be applied (after certain costs and expenses) *pari passu* towards the secured liabilities in that pool as and when each such liability fell due.

However, having provided for the establishment of the pools, the final sentence of Clause 7.6 stated that:

> '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.' [emphasis added]

This provision caused controversy because over USD 1.3 billion of secured liabilities (Short Term Liabilities), principally in the form of maturing medium term notes, fell due for payment during the Realisation Period. This sum exceeded the assets available to the Receivers, meaning that if this provision did indeed require payment of secured liabilities as they fell due (the 'pay as you go' approach), Sigma's assets would be exhausted within less than three weeks and there would be no assets left to allocate to pools for later-maturing creditors.

The arguments

The Receivers applied to the High Court pursuant to section 35 of the Insolvency Act 1986 for directions as to the correct construction of this provision. Four secured creditors, whose liabilities fell due at different times, anonymised as Parties A, B, C and D, were joined as parties to the proceedings and argued their competing positions, while the Receivers and the Trustee took a neutral stance.

Party A, whose debts fell due early in the Realisation Period, argued that the final sentence of Clause 7.6 required a strict 'pay as you go' approach. To the extent that Sigma had realisable assets and it was 'possible' to realise those and pay secured liabilities falling due during the Realisation Period, that was what was required even if it necessitated an urgent sale of assets at depressed prices and even if the assets were exhausted by those payments such that no pools could then be created. Party B, whose liabilities fell due towards the end of the Realisation Period, after the assets were likely to have been exhausted on a strict 'pay as you go' approach, argued that a *pari passu* distribution amongst all Realisation Period secured liabilities was required. Thus Party B agreed with Party A that secured creditors whose debts fell due in the Realisation Period were to be favoured ahead of later-maturing creditors, but disputed Party A's contention that as among Realisation Period creditors, a time order of priority was the correct approach.

Parties C and D argued that in circumstances where Sigma was heavily insolvent, the final sentence of Clause 7.6 did not require any species of 'pay as you go'; instead, the language of 'so far as possible' permitted the Trustee to decline to make any payments during that period. This argument contended that the Trustee should not urgently realise assets to fund a 'pay as you go' approach, but should allocate the assets to the pools and leave secured creditors whose claims fell due during the Realisation Period to their *pari passu* entitlement from the Short Term Pool along with the other Short Term Liabilities. The commercial thrust of this interpretation was a *pari passu* outcome among all the secured creditors.

The judgments below

At first instance, Mr Justice Sales upheld Party A's contention that a strict 'pay as you go' reading was correct. Parties B, C and D appealed this decision to the Court of Appeal.

The Court of Appeal, by a majority, dismissed the appeals. The majority, Lord Justices Lloyd and Rimer, found that the wording of the final sentence of Clause 7.6 was clear in imposing an obligation on the Trustee to discharge secured liabilities on the dates they fell due during the Realisation Period. They stressed that it was not the court's function to re-write the Security Trust Deed, or to create obligations which were not expressed in it, in order to avoid what may seem an unfair and unexpected result. Lloyd LJ found that the argument for *pari passu* distribution among secured creditors sought to place a weight and significance on the words 'so far as possible' that they could not bear. Rimer LJ similarly noted that although a *pari passu* distribution amongst all secured creditors had obvious instinctive appeal, the case did not involve the application of a conventional or statutory insolvency regime. Lloyd LJ distinguished the earlier SIV

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decisions of *Cheyne*[2] and *Whistlejacket*[3] on the basis that the documents considered in those cases were so different to Sigma's Security Trust Deed that they were 'of assistance only at the highest level of generality' (Lloyd LJ having been one of the Court of Appeal panel in *Whistlejacket*).

Lord Neuberger of Abbotsbury (at the time, still a Law Lord and not yet the Master of the Rolls) dissented, paying particular attention to the documentary and commercial context. His Lordship stressed that the more a particular interpretation of words produced a commercially improbable result, or one which would surprise reasonable people in the commercial world, the less likely such an outcome will have been intended and the more ready the court will be to give the words another interpretation.

Lord Neuberger considered the 'pay as you go' approach unattractive in terms of business common sense, for example because it could require Sigma's assets to be realised on a 'fire-sale' basis to the potentially extreme detriment of those whose debts fell due after the Realisation Period. He also noted that the significant impact of the timing of service of the enforcement notice in a 'pay as you go' environment meant that the outcome could be susceptible to manipulation and arbitrariness, and that a not dissimilar type of result was described as 'bizarre' by Lloyd LJ in *Whistlejacket*.[4] Lord Neuberger favoured a slight variation on Parties C and D's construction: the words 'so far as possible' meant that, while there was still a duty to pay each Realisation Period secured liability as it fell due, any payment should be limited to the same proportionate return which the Trustee was confident would be paid in respect of other Short Term Liabilities from the Short Term Pool when created.

Parties B, C and D sought and obtained leave to appeal the Court of Appeal's decision to the House of Lords.

Supreme Court judgment

In one of its first judgments, the newly formed Supreme Court (by a majority of 4-1, Lord Walker dissenting) allowed the appeals of Parties C and D and set aside the orders in favour of the 'pay as you go' approach made by the Court of Appeal and by Mr Justice Sales.

In the majority judgment, Lord Mance (with whom Lords Hope, Scott and Collins agreed) briefly summarised the principles of construction to be applied in interpreting a commercial instrument, including that words should be given their 'natural and ordinary meaning'[5] and must be set in the 'landscape of the instrument as a whole'.[6]

In many ways, the critical observation appears at the outset of his discussion:[7]

> 'In my opinion, the conclusion reached below attaches too much weight to what the courts perceived as the natural meaning of the words of the third sentence of clause 7.6, and too little weight to the context in which that sentence appears and to the scheme of the Security Trust Deed as a whole.'

Lord Mance found that, having regard to the scheme of the Security Trust Deed as a whole, Clause 7.6 (and the provisions immediately surrounding it) had been drafted on the assumption of a situation in which Sigma had enough assets to pay its secured liabilities in full. He considered that it was only in the later parts of Clause 7 that the drafter's attention had turned to contemplate a deficiency against secured creditor claims. He noted, for example, that Clause 7.6 failed to address the position of creditors whose debts fell due for payment *prior* to the Realisation Period – suggesting an assumption of solvency, and thus that there would not be any unpaid pre-enforcement debts (as in fact there were). Also, there was nothing in Clause 7.6 allowing for the payment or priority of the Trustee and Receivers' fees ahead of any 'pay as you go' payments to creditors, in contrast to the clear provision for their priority in any distribution from the pools once established. Lord Mance felt that this too suggested that no thought had been given to the possibility that Sigma's assets would be exhausted by a 'pay as you go' approach before the pools had been set up, and considered it 'remarkable' that the drafter could have envisaged such a scenario without providing for relevant fees to have priority protection.

On this basis, Lord Mance found that the final sentence of Clause 7.6 had to be interpreted in a quite different context (ie Sigma's heavy insolvency even as against secured liabilities) to that for which it was designed. In deciding upon the true construction, he was 'greatly facilitated' by what he considered to be the overall scheme of the Security Trust Deed, which envisaged sufficient assets being placed into each pool to meet the pool's liabilities in full and on time as they fell due going forward. In that context of assumed

Notes

2 *Re Cheyne Finance plc (in receivership) (No. 1)* [2007] EWHC (Ch) 2402 2, [2008] 1 BCLC 732; *Re Cheyne Finance plc (in receivership) (No. 2)* [2007] EWHC (Ch) 2402, [2008] 1 BCLC 741.

3 *Re Whistlejacket Capital Ltd (In Receivership)* [2008] EWCA Civ 575.

4 *Re Whistlejacket Capital Ltd (In Receivership)* [2008] EWCA Civ 575 at [58].

5 At [10]; *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 at 913.

6 At [9]; *Charter Reinsurance Co. Ltd v Fagan* [1997] AC 313 at 384.

7 At [12].

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solvency, at least against secured liabilities, the final sentence of Clause 7.6 was intended to put Realisation Period secured creditors in the same position as those who would fall due and be paid on their due dates once the pools were up and running.

However, in the very different context of a deficiency against secured claims and no prospect of payments in full from the pools:

> 'the approach of the courts below … elevates Realisation Period creditors to a special status, extracts them from the Pool to which the [Security Trust Deed] assigns them, distorts the apparent aim to achieve equity between all creditors by the creation of Short and Long Term Pools, and probably also distorts the relationship between the Short and Long Term Pools.'

Lord Mance could not accept that such a construction was correct, and instead favoured that advanced by Parties C and D (without expressing a view on Lord Neuberger's refinement to that formulation, on which he found that nothing turned).

Comment

In his short dissenting opinion in the Supreme Court, Lord Walker observed: 'Although I was one of those who gave permission for a further appeal … I find, on closer consideration, that the case involves no issue of general public importance. There is no doubt as to the principles of construction to be applied.'

Whatever view one takes of the 'public importance' of the case, the suggestion that the correct approach to construction is uncontroversial may at first blush seem surprising in circumstances where the case provoked such a divergence of judicial opinion. Neither the Court of Appeal nor the Supreme Court could reach a unanimous decision as to the correct construction, and in all the nine eminent judges who heard the case were divided 5-4 as to the correct interpretation (the bare majority view in the end being that which prevailed in the Supreme Court).

It is pertinent to note in this context that the arguments at each of the three stages were substantially the same, as reflected in the reasoned judgments of Mr Justice Sales, the judges of the Court of Appeal and Lord Mance. The 'pros and cons' of each competing construction were vigorously ventilated before each tribunal, albeit with slight developments as the case progressed, and it was not the case that a new 'silver bullet' emerged in the Supreme Court to sway that tribunal from the path which had been adopted below. The correct outcome might fairly be said in these circumstances to be at least in part a matter of judicial taste.

Aside from the trite observation that such cases highlight the premium on clear drafting, and the difficulties for commercial parties and their advisers which often arise in complex documents, the question remains whether *Sigma* reflects wider themes such as, in the spirit of *Chartbrook Ltd v Persimmon Homes Ltd*,[8] a more commercial over literal approach to construction in England's highest court.

In this regard, one point of interest is the divergent judicial approach towards the fact that the document to be construed was a complex Security Trust Deed which had no doubt received considerable legal attention and governed relationships between sophisticated institutional parties. The judges who favoured the more literal 'pay as you go' approach seemed to place greater weight on these factors. Mr Justice Sales considered as 'powerful points' that these were:

> 'sophisticated and carefully drafted documents, prepared by and entered into with the advice of specialist commercial law firms, made by sophisticated commercial parties well able to determine the nature of the rights and obligations assumed thereunder and whose intention should be taken from the clear and natural meaning of the words which are used'

Likewise, in rejecting Parties C and D's argument that 'so far as possible' was concerned with preventing payments in circumstances where not all secured creditors would be paid in full, Rimer LJ observed:

> 'The trust deed is a 45-page document reflecting the considered input of (probably) a team of commercial lawyers. It is inconceivable that if [Parties C and D's argument] was the thought behind the qualification in the last sentence of clause 7.6, the qualification would have been articulated by the use of the phrase 'so far as possible' rather than by spelling it out expressly.'

In the Supreme Court, Lord Walker too noted that 'It is not for the Court to make a new contract for experienced commercial operators advised by expert lawyers'.

In sharp contrast, the judges who favoured the construction leading to a *pari passu* outcome paid much more attention to the fallibility of the drafting process in support of their more commercial approach, which sought to glean the overall intention of the parties from the document as a whole without too much weight being given to particular words which appeared to run counter to that intention. For example, Lord Neuberger

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8 [2009] UKHL 38.

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noted that complex documents such as the Security Trust Deed:

> 'often have different provisions drafted inserted or added to by different lawyers at different times; they often include last-minute amendments agreed in a hurry, frequently in the small hours of the morning after intensive negotiations, with a view to achieving finality rather than clarity; indeed, often the skill of the drafting lawyer is in producing obscurity, rather than clarity, so that two inconsistent interests can feel satisfied with the result.'

Lord Mance also played down the relevance of the document having been carefully prepared by experienced lawyers and, most pertinently of all, Lord Collins (with whom Lords Mance and Hope agreed) observed that: 'In complex documents of the kind in issue there are bound to be ambiguities, infelicities and inconsistencies. An over-literal interpretation of one provision without regard to the whole may distort or frustrate the commercial purpose.' This preceded his observation, based on the well-known decision in *Antaios Compania Naviera S.A. v Salen Rederierna A.B.*,[9] that detailed semantic analysis must give way to business common sense.

The other question which has arisen from *Sigma* and from the other SIV disputes is the role that the *pari passu* principle plays in informing the judicial approach. Plainly, none of the eminent judges who considered the *Sigma* case went so far as to identify any presumption in favour of a contractual interpretation leading to a *pari passu* outcome for creditors. Likewise, each of those who favoured a 'pay as you go' interpretation were at pains to point out that the creditors had freely contracted for a process which was, on any analysis, very different from a statutory insolvency proceeding, such that (in the words of Lord Walker) it was: 'therefore necessary to repress any instinctive feeling (and it is, I acknowledge, a strong instinctive feeling) that *pari passu* distribution at the earliest practicable date is the most natural (one might almost say the only rational) solution'.

That said, there is little doubt that the commercial consequences of a 'pay as you go' construction, and the substantial (and somewhat random) inequality in creditor treatment which would result, played a part in the conclusions of both Lord Neuberger[10] and Lord Mance. However, Lord Mance in particular anchored those concerns not to some underlying policy principle favouring *pari passu* treatment of creditors, but rather to what he considered to be the intention of the parties to the Security Trust Deed to create a broadly *pari passu* outcome by way of the pooling mechanism.[11]

Whilst of course secured parties are free to contract for distribution mechanisms which are at odds with the *pari passu* principle, it is suggested that *Sigma* does reflect the need for very clear provisions to justify the unequal treatment of creditors who, in other parts of the applicable contractual framework, are expressed to rank equally alongside each other. Given the role of *pari passu* distribution as a cornerstone of English insolvency law and its intuitive fairness, one can see that in contractual debt arrangements which have an underlying theme of equal ranking debts, the courts are likely to be slow to find that individual provisions within that framework inadvertently, or less than transparently, undermine that principle of equal treatment.

Notes

9 [1985] A.C. 191 at 201.

10 At [105].

11 At [32], Lord Mance refers to the document's 'apparent aim to achieve equity between all creditors by the creation of Short and Long Term Pools'.

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