

# Insight: Dispute Resolution

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## Sigma Finance Corporation: substituting a commercial bargain through the guise of interpretation?

**The first appeal ruling from the newly formed UK Supreme Court concerned the construction of a clause setting out the distribution of assets in a collapsed structured investment vehicle ("SIV"). For the creditors attempting to salvage the remains of the SIV, and onlookers in similar situations, the judicial process has been a rollercoaster ride which has left them reeling.**

The Court of Appeal warned in *Megaro v Di Popolo Hotels Ltd* [2007] EWCA Civ 309 that "it is not for the court, through the guise of interpretation to substitute for the bargain which the parties did make a different bargain which in its view they would have made if they had been better advised or had had better regard for their own interests." The case of *Re Sigma Finance Corporation (in administrative receivership)* [2009] UKSC 2, is yet another example of how the English Courts are crossing that boundary in increasing fashion, leaving contracting parties in a state of uncertainty when it comes to the question of contractual interpretation.

### Sigma Finance: the facts

Sigma Finance Corporation ("Sigma Finance"), similarly to other SIVs, invested in asset backed securities and other instruments using funds raised by issuing or guaranteeing medium term notes as well as liquidity from other sources such as repurchase contracts ("repos") and capital notes. At its peak, Sigma Finance's assets were reportedly worth US\$27 billion. This substantial asset base formed the security for all of Sigma Finance's principal creditors pursuant to a Security Trust Deed. As the sub-prime mortgage market unravelled in the US in 2007, the value of Sigma Finance's asset backed securities tumbled. In a desperate attempt to raise financing, Sigma Finance entered into further repos which allowed the counterparties to make "margin calls" should the value of its assets fall below certain levels. The market worsened and, in September 2008, Sigma Finance failed to honour the margin calls it had received. One of Sigma Finance's liquidity providers subsequently gave notice of an event of default. This triggered the start of a 60 day "Realisation Period" pursuant to the terms of the Security Trust Deed. At the end of the Realisation Period, the security trustees had to create pools of assets which matched the maturities of Sigma Finance's short term and long term liabilities. Each class of creditor was then to be confined to recovery out of the assets allocated to its particular pool. At this stage, however, the value of Sigma Finance's liabilities greatly outweighed the value of its assets.



Increasing regulatory burdens, internationalisation of deals and heightened cooperation between national and multinational enforcement authorities means that it is vital to have robust dispute avoidance and management strategies in place. Our London dispute resolution team of 50 lawyers can help you develop effective mechanisms to avoid disputes before they arise, and help achieve fast, cost effective solutions when they do.

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Sigma Finance’s receivers applied to the High Court in November 2008 for directions regarding the proper construction of Clause 7.6 of the Security Trust Deed. It provided that, during the 60 day 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 [Sigma Finance].” Did Clause 7.6 provide for short term liabilities to be paid when due during the Realisation Period (the so-called “pay as you go” approach), or should they stand in line and be paid on a *pari passu* basis with all the other secured liabilities falling due at a later date? It was accepted by the parties that if the short term liabilities were required to be paid by the receivers as they fell due during the Realisation Period, all of Sigma Finance’s assets would be exhausted and there would be nothing left to pay the, otherwise identical, secured liabilities which matured at a later date.

### The High Court and Court of Appeal decision

Adopting a literal approach to the clear, albeit oddly drafted, wording of Clause 7.6 of the Security Trust Deed, the High Court held that it necessitated the receivers to pay short term liabilities on a pay as you go basis during the Realisation Period. The High Court’s decision was appealed to the Court of Appeal which, by a majority, upheld the High Court’s decision. Rimer LJ, sitting in the Court of Appeal, said of his decision “many lawyers may be instinctively surprised at such a conclusion, since the culture with which they will be familiar is one ordinarily providing for a *pari passu* sharing in an insolvency...But we are not here concerned to apply a conventional insolvency regime. The [Security Trust Deed] reflects a commercial bargain made between, or on behalf of, interested parties and our task is to interpret what that

*bargain was...I have expressed my view as to what it was, and the court’s duty is to give effect to it. It is not the court’s function to re-write it.”*<sup>1</sup>

### The Supreme Court Judgment

The majority of the Supreme Court reversed the conclusion reached by the High Court and the Court of Appeal. Adopting a more purposive approach, it held that the receivers were not required by Clause 7.6 to pay the short term liabilities as they fell due in a situation where there were insufficient funds available to pay all of Sigma Finance’s secured liabilities in full. Referring to the Court of Appeal’s judgment, Lord Mance stated “*In my opinion the conclusion 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...caution is appropriate about the weight capable of being placed on the consideration that this was a long and carefully drafted document...Even the most skilled drafters sometimes fail to see the wood for the trees, and the present document on any view contains certain infelicities...*”<sup>2</sup>

### Implications

Given the fact that the case rested on the specific interpretation of a clear, although rather ill drafted, clause, its value as a precedent for the interpretation of similar clauses is somewhat limited.<sup>3</sup> Nonetheless, the judgment does highlight worrying truths: the sometimes inconsistent and contradictory decisions given when questions of contractual construction are put to the English courts and the tendency of the courts to stray dangerously close to substituting the commercial bargain made by the parties through the guise of interpretation.

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1 At paragraph 92.

2 At paragraph 12.

3 Indeed, the Court of Appeal itself distinguished the Sigma Finance case from other SIV cases where the courts have considered similar problems of interpretation (i.e. *Re Cheyne Finance plc (in receivership) (No 1)* [2008] 1 BCLC 732, *Re Cheyne Finance plc (in receivership) (No 2)* [2008] 1 BCLC 741 and *Re Whistlejacket Capital Ltd (in receivership)* [2008] EWCA Civ 575) on the basis that the terms of the relevant provisions in question were so different.

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## The vagaries of contractual construction

The English courts' approach to contractual construction, famously restated by Lord Hoffmann in *Investors Compensation Scheme v West Bromwich Building Society* [1998] 1 WLR 896,<sup>4</sup> has long since been the subject of intense debate. Whilst Lord Hoffmann's restatement is regarded as the starting point for a consideration of the principles of construction, it is just that, a starting point. It is not always clear what the English courts will decide when construing contracts and much appears to depend upon the individual case in question. It is this ability of the courts to come to very different conclusions in very similar cases as to what it considers to be the objective intention of the parties that is troublesome.

The case of Sigma Finance is a stark reminder of the vagaries of the approach taken to contractual construction by the English courts with each appellate court coming to opposing decisions when interpreting the same clause. The Court of Appeal adopted a literal interpretation of the "waterfall" clause in the Security Trust Deed, placing importance on the fact that the deed had been drafted by "*(probably) a team of commercial lawyers.*" In contrast, the Supreme Court adopted a more purposive approach and even went so far as to say that caution should be placed on long and carefully drafted documents. Even within each court's judgment there are contradictions in the approach taken by the individual judges. Whilst Lord Mance in the Supreme Court looked to Lord Hoffmann's restatement of principles as the starting point for his analysis, Lord Collins opined that, as the Security Trust Deed secured a variety of creditors who held different instruments issued at different times, this was "*not the type of case where the background or matrix of fact is or ought to be relevant, except in the most*

*generalized way. I do not consider, therefore, that there is much assistance to be derived from the principles of interpretation re-stated by Lord Hoffmann...*"<sup>5</sup>

The contrasting results in two other recent cases concerning the priority of creditors of SIVs only exacerbate the uncertainty. In *Re Cheyne Finance plc (in receivership) (No. 1)* [2008] 1 BLC 732, Briggs J adopted a pay as you go construction to a clause in a trust deed providing for the satisfaction of "*senior obligations as and when the same become payable*" in the period following an enforcement event but prior to insolvency. Briggs J accepted that such a construction would result in an inequality between creditors however, "*the unfairness in question arises primarily from the narrowness of the definition of insolvency event deliberately chosen by the parties...*" [emphasis added].<sup>6</sup> When a similarly worded clause appeared before the Court of Appeal in *Re Whistlejacket Capital Limited (in receivership)* [2008] 2 BCLC 683, it unanimously reversed the decision of the High Court. The Court of Appeal held that the trust deed could not be read as having been intended to prescribe priority within the class of senior creditors; the effect of a pay as you go approach would be "*haphazard, arbitrary and unpredictable.*"<sup>7</sup> Had the trust deed in question intended to impose a priority within creditors of the same class on the basis of the maturity date of each investment, the judges held, the deed would have been more explicit.<sup>8</sup>

The recent case of *Chartbrook Ltd v Persimmon Homes Ltd and anor* [2009] UKHL 38 is yet another example of the anomalies which can arise in the varying approaches adopted by the English courts to contractual construction, this time, however, in the context of a commercial contract. The House of Lords overturned the decision of the Court of Appeal in relation to the construction of a payment

clause. Lord Hoffmann, in his last judgment before his retirement this summer, held that the literal meaning of the payment clause made certain other provisions in the agreement appear arbitrary and irrational, so the "*grammatical ambiguity*" had to be resolved by considering the business purpose of the provision. In contrast, the Court of Appeal had found that the words used in the clause were "*clear, certain and unambiguous*" (albeit leading to a result which, as was clear from other inadmissible evidence, had not been the parties' actual intention).

## Conclusion

As creditors continue to salvage their wrecked investment vehicles from the fall out of the financial markets, no doubt more cases involving the priority of creditors in structured investments will come before the English courts. So where does this string of recent cases leave investors in situations similar to that of Sigma Finance? The answer is unclear. Ideally, every term in every contract would be drafted with precision and clarity leaving no room for manoeuvre. The reality is, however, somewhat different. In circumstances where multiple parties are involved, negotiations are pressurised, and contracts are complex, infelicities and errors will arise. Where parties seek the English court's assistance to resolve these issues, ultimately, it appears that the parties will be at the whim of the particular judge or judges before them.

Whilst there is no doubt that a certain level of pragmatism must be applied in cases such as Sigma Finance, where there was a systematic failure of the SIV in a disorderly market, the Supreme Court's decision is stepping dangerously close to substituting a different bargain which in its view the secured creditors would have made had they had better regard for their own interests.

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4 At paragraph 912 H

5 At paragraph 37.

6 At paragraph 27.

7 At paragraph 58.

8 See paragraph 56.

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