

Insight: Derivatives

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Swap termination costs recoverable from third party

In *Parbulk AS v Kristen Marine SA, Aurele Trading Inco [2010] EWHC 900 (Comm)*, the High Court held that the costs of terminating a swap agreement were recoverable from the Defendants in circumstances where it was reasonably foreseeable that the Claimant would hedge its interest risk under a loan.

Mr Justice Burton summarised the factual background as follows:

- "2 The background is that the four SPVs became (by novation) party to four shipbuilding contracts dated 21 December 2005 with a Chinese shipyard, being Jiangsu Eastern Shipyard and Jiangsu Holly Corporation, for the acquisition of four handysize bulk carriers ("the vessels"). The Defendants decided to restructure their finance of the project by means of a sale and leaseback transaction entered into with the Claimant, which is controlled by a small group of investors sourced in the Norwegian market by Pareto Private Equity ASA ("PPE") as arranger. Hence the SPVs entered into the four [Memoranda of Agreement ("MoAs")] to sell the four vessels to the Claimant, and the Claimant at the same time entered into four Bareboat Charters to charter the four vessels back to the SPVs...
- 5 The sale price receivable by the SPVs under the MOAs totalled US\$143.5 million, which was considerably more than the purchase price which the SPVs were required to pay under the Shipbuilding Contracts (totalling approximately US\$102 million). The charter income payable by the SPVs to the Claimant was fixed by subclause 38.1 of each Charter: it was required to be paid on stringent terms, to ensure payment of hire in full without discount, set off or counterclaim, and despite any contingency, including any possible failure by the Claimant (subclauses 38.4 and 38.5), and all relevant obligations, in respect of maintenance and repairs and insurance, and all rights in respect of operation, and the flag and name of the Vessel, were wholly vested in the SPVs (Clauses 10 and 13).
- 6 In order to provide part of the finance for the price paid by it to the SPVs as above, the Claimant entered into loan terms with its lenders. By a Secured Term Loan Facility Agreement dated 9 October 2007 ("the Loan Agreement") the Claimant borrowed US\$129,150,000 from the French bank Calyon SA ("Calyon"). The parties to the agreement were the Claimant, as Borrower, "the Financial Institutions listed in Schedule 1," being in fact because there was only one such Bank listed in Schedule 1 in respect of the totality of the US\$129,150,000 – Calyon, and Calyon as "Agent, Arranger and Swap Bank." The Loan Agreement provided for interest to be payable on



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a floating basis, whereas the Claimant's income was, as set out above, fixed by reference to the charter income under the Bareboat Charter. Accordingly, by subclause 18.15 of the Loan Agreement, the Claimant was required to hedge the interest rate fluctuation risk for the loans for a period of at least three years by entering into with the Swap Bank (Calyon) a Swap Agreement (which was defined in subclause 1.1 as meaning "An ISDA Master Agreement entered into or to be entered into by [Calyon] and [the Claimant], as amended from time to time, and confirmations of the transactions made or to be made thereunder") and certain transactions thereunder. By subclause 4.1(a) and paragraph 8 of Schedule 2 of the Loan Agreement, the Claimant was obliged, within 20 business days from 9 October 2007, to provide to Calyon the Swap Agreement duly executed by the Claimant and Calyon "together with evidence that the interest rate exposure in respect of the Loans has been fixed for a period of at least 3 (three) years." The Claimant entered into the ISDA Master Swap Agreement with Calyon on 9 October 2007, and, pursuant to it, on the same day (within the 20 business days), entered into four Swap transactions, each for five years, being the five year "initial charter period", pursuant to subclause 37.1 of the Charter, for the full amount of the unrepaid loan.

9 In the event there was substantial delay by the Shipyards in carrying out their obligations under the respective Shipbuilding Contracts. Given the "en bloc" nature of the transactions, as discussed, I only need to deal with the dates in respect of the first such

vessel. The delivery date for such vessel under the Shipbuilding Contract was 31 July 2008, and the cancellation date (by reference to the right of the SPV to cancel after an excessive delay, of 210 days of permissible and non permissible delay) was 26 February 2009...

Following such delay, the Claimant terminated the transaction (which it was entitled to do) and issued a claim against the Defendants for costs incurred in terminating the loan and the swap. On this point, Mr Justice Burton said:

"11 The Claimant's deposit was returned to it, but it now claims, pursuant to Clause 14, its "proven expenses including, but not limited to, legal costs and breakage cost with the Buyer's lenders." These fall into two categories¹:

i) The sums flowing from the cancellation of the Loan Agreement and the breaking of the Swap Agreements ("swap costs"). The Loan Agreement was terminated by Calyon on 18 March 2009 by virtue of the termination of the MoAs (subclause 19.11), and the Swap Agreements on 19 March 2009 by virtue of the termination of the Loan Agreement (subclause 5(b)(v), 6(b) and Schedule Part I(h)(ii) of the ISDA Master Agreement). The notice by the Claimant dated 27 February 2009, referred to in paragraph 10 above, concluded by stating that, in the event that it cancelled the MoAs, there would be a claim pursuant to Clause 14 and that:

"As you know, we have hedged our interest rate exposure under the Calyon SA loan advanced to us to finance the ship purchases. We understand that the breakage

costs that would be payable if those swap transactions were terminated today would likely be in the region of US\$14 million. That is a figure that may fluctuate upwards or downwards in the current market conditions."

The cost which has eventuated, and which has been paid by the Claimant to Calyon, was calculated in accordance with the provisions of the ISDA Master Agreement, and this is agreed as a calculation at either US\$15,185,647 (Claimant's calculation) or US\$14,335,647 (US\$850,000 less) (Defendants' calculation) or US\$14,833,631 (the Claimant's reworking of the Defendants' calculation)."

Counsel for the Defendants, Mr Tozzi submitted, *inter alia*, that:

- a) the swap costs claimed (arguably) did not fall within the scope of the wording in Clause 14 of the MoA: "breakage cost with the Buyer's lenders";
- b) if the swap costs were not breakage costs, then the swap costs claimed were, by virtue of, or notwithstanding the *eiusdem generis* rule², not "proven expenses"; and
- c) such swap costs were not foreseeable (i.e. too remote) and not reasonably incurred, and therefore not recoverable.

Breakage Costs

The Defendants argued that the swap costs arose from the swap rather than the loan and therefore could not be construed as "breakage costs". The Defendants called an expert witness to support this argument. On this point, Mr Justice Burton held:

¹ The second category is not relevant for the purpose of this briefing and it not further discussed. Footnote added by White & Case LLP.

² *Eiusdem generis* is a rule of statutory interpretation that has been extended to the interpretation of contracts. The rule of interpretation applies where several words precede a general word - commonly lists of words. The meaning of the general word is restricted to the meaning of the preceding words, with the effect that the general word does not expand the beyond the subjects or classes of the preceding words. For instance, where an exclusion clause in an insurance contract states that liability will be excluded by damage caused by "acts of god, flood, fire or otherwise," the term "otherwise" relates only to damage of the same class as the preceding words. Thus the clause would not exclude liability for damage caused by riots, but may do for damage caused by gas leaks. The term "*eiusdem generis*" may be read as "of the same class." The effect of the rule of interpretation is usually circumvented in contracts by use of the words, "without limitation" or "without limit."

"I am satisfied that the swap losses were breakage cost in respect of the financing arrangements by the Claimant, being the sums that the Claimant had to pay out to Calyon as a consequence of the early termination of those arrangements... in my judgment, the use of the word "with" in the phrase "breakage cost with the Buyers' Lenders" is wide enough to cover arrangements of an ancillary kind such as a swap transaction, and is not limited to breakage cost of the loan made by the Buyers' Lender."

Proven Expenses

In addition to disputing the correct construction of sentence (3) of Clause 14 of the MoA which would entitle the Claimant to recover its proven expenses, the Defendants submitted that the sums flowing from the cancellation of the swap did not fall within the definition of proven expenses. On this point, Mr Justice Burton held:

"Insofar as the Claimant contends that, if (contrary to its contentions) the swap costs are not comprehended within breakage cost with the Buyers' lenders, then they would be a similar kind of cost, not expressly set out as an exemplar, but nevertheless within the definition of "proven expenses," *eiusdem generis* with the examples which are given, Mr Tozzi submits the contrary. This is, he submits, for two reasons. First...there is a deliberately chosen different form of wording in the MoA than that adopted in the Charter. Secondly, he puts forward a submission by reference to a further construction of Clause 14... This contention is that sentence (3) of Clause 14 addresses the remedy of cancellation provided for up to that stage within the Clause, together with provision for limited expenses.

Sentence (4) then provides for "due compensation to the Buyers for their loss and for all expenses," where there is the necessary proof not only of default by the Seller, but also of negligence. Mr Tozzi submits that the expenses provided for in sentence (3) must be more limited, lesser, than those provided for in sentence (4), and thus submits that such losses as the swap losses now sought to be compensated may fall within the definition of expenses within sentence (4), but not within the definition of proven expenses in sentence (3). I should say immediately that I do not accept that this construction is arguable. It seems to me obvious that sentence (4) is intended to give an entirely different remedy. It is not dependent upon there having been cancellation (as is made expressly clear at the end of the sentence). It is also necessary for the Buyers to prove negligence by the Sellers. If such negligence is proved, then a wider measure of damage can be recovered, and not just expenses but loss can be recovered, e.g. loss of profit, which would plainly not fall within the ambit of sentence (3). Whereas I agree that sentence (3) is dealing with the consequences of cancellation, while sentence (4) is not, there is in my judgment no justification whatsoever for any difference in the definition of expenses. If sentence (3) applies, then the deposit is recoverable together with proven expenses. If sentence (4) applies then, provided negligence is proved, irrespective of cancellation, the Buyers can recover "their loss... **and** all expenses..."

If I were wrong that the swap costs were comprehended by breakage cost with the Buyers' Lenders, then I would

accept Mr Matthews' [Counsel for the Claimant] alternative submission that they were in any event comprehended by proven expenses, with its definition by reference to "including, but not [being] limited to" the examples therew set out. I have already rejected...Mr Tozzi's argument that the definition of proven expenses in sentence (3) was in some way limited by sentence (4). If, for some reason, these swap costs in this case were not breakage cost with the Buyers' Lenders, whether because of the precise role of Calyon or because they arose from an ancillary agreement and not from the Loan Agreement itself, I am satisfied that they are sufficiently close to the example given as to be *eiusdem generis*, and thus fall within the definition of proven expenses."

Reasonably foreseeable costs

The Defendants denied that they had notice of the swap and, in any event, since the Claimant knew, or ought to have known, that delivery of the vessels was to be delayed, it was unreasonable for the Claimant to have entered into the swap when it did and therefore such entry into the swap was not reasonably foreseeable. On this point, Mr Justice Burton held:

"31 The Defendants say that they did not know the terms of the Loan Agreements or the underlying ISDA Master Agreement...Mr Maniatakis [the Chief Financial Officer of the Defendants] says that the Claimant did not "indicate when it intended to enter into any swap agreements" and "on this basis" the Defendants did not know the Claimant was exposed. However, Mr Matthews relies on subclause 12(b) of the Charters...³ Mr Tozzi submits that this is only a deeming provision, and that the Defendants are only deemed to know

³ The relevant section of subclause 12(b) to which Mr Justice Burton is referring is as follows: "The Charterers confirm that...they have acquainted themselves with all relevant terms, conditions and provisions of the Financial Instruments [i.e. the Loan Agreement] and agree to acknowledge this in writing in any form that may be required by the mortgagee(s)";

the contents of the Loan Agreement for the purposes there set out. However, I do not accept that the provision is simply relevant for the purposes of such deeming. The question is whether it was reasonably foreseeable that the Claimant would enter into a swap agreement which fixed the interest rate exposure in respect of the loan. Mr Matrapazidis [a consultant to the Defendants] says he "does not recall having given any particular consideration to the terms relating to swap agreements and hedging transactions". The Defendants knew of and had available to them the Loan Agreement containing the hedging obligations – which they only had to ask for if indeed they did not have a copy, and which they were required to study for the purposes of "acquainting themselves" with the terms with which they were confirming, by subclause 12(b), that they had become acquainted. When this is taken together with the express provision of subclause 47.3.3 of the Charter⁴, which further put them on notice, I am entirely clear that the Claimant's entry into the hedging arrangements was indeed reasonably foreseeable, and hence not too remote. Compliance with the hedging obligations also cannot, in my judgment, be characterised even arguably as unreasonable..."

It is reassuring to see that the High Court took a commercial approach to foreseeability of loss in light of the common practice of including hedging arrangements as part of an overall financing when considering the losses suffered by a financing party caused by the actions of a commercial counterparty. However, that is no substitute for making specific provision in contracts dealing with swap financing costs taken out by the financier and there could be specific instances where such swap costs would not be recoverable, absent specific contractual agreement to the contrary.

⁴ The relevant section of subclause 47.3.3 of the Charter to which Mr Justice Burton is referring is as follows: "*all costs, expenses, damages and losses incurred by the Owners... (including, but not limited to... all financing break funding costs incurred in relation to any early termination of any interest rate swap transaction entered into by the Owners in connection with the financing of the Vessel)*".