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SIGMA FINANCE: FOCUSING ON THE COMMERCIAL CONTEXT

By Simon Willis and Stephen Day

The Supreme Court has recently overruled the decisions of the lower courts on the correct interpretation of the terms of a security trust deed (STD) governing the rights of the secured creditors of Sigma Finance Corporation (Sigma), a structured investment vehicle (SIV) (*In Re Sigma Finance Corporation (in administrative receivership* [2009] *UKSC 2*).

The majority of the Supreme Court found that the lower courts had given too much weight to the natural meaning of the words used in the STD and insufficient weight to the commercial context, echoing the sentiments of the House of Lords in another recent case: *Chartbrook Limited v Persimmon Homes Limited and others* ([2009] *UKHL 38; see News brief "The exclusionary rule: Hoffmann's last word", www.practicallaw.com/0-386-6895*).

The decision is a further illustration of the extent to which judges, particularly in the appeal courts, may be prepared to depart from the ordinary meaning of the words used where that leads to an interpretation which is contrary to the judge's perception of the commercial purpose of the agreement.

The facts

Sigma invested in asset-backed securities and other financial instruments. These investments were financed by issues of US and Euro commercial paper and medium term notes (MTN), the holders of which became secured creditors of the SIV. In common with other SIVs, Sigma was "insolvency remote", meaning that by the terms of its governing documents, secured creditors were not entitled to resort to normal insolvency procedures but instead had agreed to limit their rights, in the event of an enforcement event, to the scheme of distribution set out in the STD.

The scheme of distribution was triggered in October 2008 when Sigma failed to meet a payment due to a creditor and as a consequence entered "enforcement": an operating state where control of its assets passed to the security trustee to be distributed to secured creditors under the terms of the STD. At the time it entered enforcement, Sigma had a massive shortfall between its available assets and secured liabilities.

The dispute

Following enforcement, the STD required the administrative receivers appointed by the security trustee to establish, by the end of a 60 day realisation period, a "short term pool" of assets and a number of "long term pools". The intention was to match the maturity dates of the assets in the short term pool to the maturity dates of the short term liabilities (liabilities falling due for payment less than 365 days after enforcement) and to achieve a similar match between assets in the long term pools and long term liabilities (liabilities falling due for payment more than 365 days after enforcement). Once the realisation period had passed secured

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creditors would be paid, on their maturity dates, pari passu from the assets available in the pools to which they had been matched.

The dispute concerned how and when secured creditors to whom payments became due during the realisation period should be paid. The critical clause in the STD was clause 7.6, which provided that, during the realisation period, the administrative receivers should "so far as possible" discharge on the due dates therefor any Short Term Liabilities falling due for payment during such period,."

A, a holder of MTNs which were due to be paid by Sigma during the realisation period, argued that the correct construction of the STD was that it required secured creditors to be paid in full on their due dates during the realisation period even though this would, in the financial circumstances in which Sigma found itself, exhaust all available assets before the end of that period.

Other, later maturing, secured creditors (C and D) argued that where there was a significant shortfall in assets, the STD should be interpreted so that secured creditors maturing during the realisation period would receive the same pari passu level of distribution as those creditors who matured after the realisation period and who were to be paid from the short term pool.

The judgment

The judge at first instance and the Court of Appeal agreed that the ordinary meaning of the words used in clause 7.6 was clear and supported A's interpretation. They concluded that, while perhaps giving a surprising result in the circumstances (in that it effectively left the majority of Sigma's creditors with no recovery), A's interpretation produced a coherent and workable scheme for distribution, consistent with the context and the scheme of the rest of the STD. The surprising result was no reason to depart from the ordinary meaning of the words used. The court's duty was to give effect to the bargain the parties had made not to re-write it.

The Supreme Court disagreed by a majority of four to one. Lord Mance, who gave the leading judgment, commented that the lower courts' conclusion attached too much weight to what the courts perceived as the natural meaning of the words and too little weight to the context in which the words appeared and to the scheme of the STD as a whole.

Clause 7.6 appeared in a context where the underlying assumption was that all secured liabilities would be covered and therefore no issue of priority would arise. The basic scheme of the STD involved the creation of a short and of long term pools from which pari passu distributions in respect of each such pool would be made. Against that background, Lord Mance found that the aim of clause 7.6 was to put realisation period debts in the same position as other short term liabilities and A's construction did not represent the intention of the parties to the STD.

Lord Collins (who agreed with Lord Mance) warned of giving an over-literal interpretation to documents which may distort or frustrate the commercial purpose.

Lord Walker (dissenting) did not think that the fact that the effect of the STD, in a situation which the parties never contemplated, may appear fortuitous or arbitrary should carry much weight. Like the majority in the Court of Appeal, Lord Walker expressed the view that it was not for the court to make a new contract for experienced commercial operators advised by expert lawyers.

End note

This case demonstrates that the line between giving weight to the commerciality of a provision and re-writing an agreement can become a fine one and that judges may disagree as to where that line should be drawn. Those drafting or interpreting contracts should bear in mind the willingness of judges to depart from the ordinary meaning of the words used if it is perceived to be at odds with the commercial context.

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