A CAUTIONARY TAEL – SUPREME COURT DECISION ON LMA SECONDARY TRADE DOCUMENTS – TAEL ONE PARTNERS LIMITED V MORGAN STANLEY CO INTERNATIONAL PLC

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Legal Briefings – By **Paul Apathy** and **Kate Podzorova**

The Tael case concerns LMA secondary trading documentation, and specifically the allocation of a payment premium between the buyer and seller.

After a number of appeals, the case reached the highest court in England, the Supreme Court (formerly the House of Lords). Whilst the LMA secondary trading documentation is governed by English law, it is used to trade loans in many jurisdictions around the world and therefore the decision is of interest to those participating in the secondary debt markets generally.

The Supreme Court held that although the payment premium effectively acted as an uplift to the interest paid under the loan, it did not 'accrue' until the loan was prepaid (some time after the trade). Accordingly, under the LMA standard documentation, the buyer did not need to account to the seller for any part of the payment premium when it was ultimately paid by the borrower.

The decision highlights the dangers of using standard form documentation where loan transfers involve complex or ongoing payment obligations. It is a stark reminder that standard form documentation cannot always adequately reflect the parties' intentions. Whenever using standard form documentation, parties should consider the extent to which additional terms or variations are necessary, or even whether bespoke legal documents may be more appropriate, so as to avoid future costly disputes between the parties.

BACKGROUND

Tael was one of several lenders in a US $100m syndicated loan to Finspace SA. On 14 January 2010 Tael transferred US $11m of its US $32m participation to Morgan Stanley pursuant to a trade confirmation that incorporated the Loan Market Association (LMA) standard terms and conditions for par trade transactions at that time (the **LMA Standard Terms**).[1] The parties agreed under a purchase price letter that the purchase price was US $11m plus accrued interest for the three month period prior to the trade date.

PREPAYMENT AND THE PAYMENT PREMIUM

The loan agreement provided for a payment premium to be paid by Finspace SA when the loan was prepaid or repaid in full. The premium was a lump sum payment to the lenders that was intended to enhance the lender's overall return to a total of 17% or 20% per annum depending on the circumstances of repayment or prepayment as outlined in the loan agreement (when factoring in the interest payable on the loan at 11.25% and any break costs payable).

The loan was prepaid by Finspace SA on 16 December 2010 (some time after the loan trade described above). By this time Morgan Stanley had on sold the $11m participation to Spinnaker Global Strategic Fund, who was the recipient of the repayment and the payment premium from Finspace in respect of that participation.

TAEL'S CLAIM

Tael and Morgan Stanley had not made any specific agreement regarding the treatment of any payment premium in the trade confirmation or pricing letter agreed between them at the time of the trade.

However, Tael claimed that Morgan Stanley was required under the LMA Standard Terms to pay to it an amount equal to that part of the payment premium that had 'accrued' as at 14 January 2010 (on the US $11m participation it transferred to Morgan Stanley).

The parties had agreed in the trade confirmation that accrued interest under the loan was to be 'Paid on Settlement Date'. This meant that under Condition 11.3 of the Standard Terms the buyer was required to pay to the seller at settlement an amount equal to the amount of any interest or fees accrued up to the settlement date.

However, Tael based its primary argument on Condition 11.9 of the Standard Terms which provided:[2]

"Unless these Conditions otherwise provide …any interest or fees (other than PIK Interest) which are payable under the Credit Agreement … which are expressed to accrue by reference to the lapse of time shall, to the extent they accrue in respect of the period before (and not including) the Settlement Date, be for the account of the Seller…"

Tael argued that the payment premium was a fee 'expressed to accrue by reference to the lapse of time' and that the requirement that it should be 'for the account' of the seller (Tael in this case) meant that Morgan Stanley was required to pay it such amount.

LOWER COURT JUDGMENTS

High Court decision

At first instance, the English High Court ruled in favour of Tael.

Popplewell J held that the payment premium performed an analogous function to interest, but was paid on a deferred basis when the loan was repaid. Part of the payment premium accrued 'in respect of' the period prior to the Settlement Date for the purposes of Condition 11.9(a), even if the right to payment arose after the Settlement Date

In reaching this conclusion, Popplewell J took the view that Condition 11.9(a) was intended to cover a wider category of fees and interest than that already covered by Condition 11.3(a). Accordingly, it was envisaged that something may accrue 'by reference to the lapse of time' and accrue 'in respect of the period prior to' the Settlement Date, but not have accrued *up to* the Settlement Date.

Court of Appeal decision

An appeal against the first instance decision was allowed by the Court of Appeal.

On appeal, Tael accepted that it was not entitled to payment of the premium under Condition 11.3(a) because the Payment Premium had not accrued on the Settlement Date, and therefore relied solely upon Condition 11.9(a).

The Court of Appeal held that Condition 11.9(a) did not create any extra entitlement beyond that in Condition 11.3(a). The decision was based on several considerations including that Condition 11.9 was entitled 'Allocation of interest and fees', other Conditions used words relating to payment (whereas Condition 11.9 only referred to amounts being 'for the account of' a party) and that there was no mechanism in the document for the buyer to inform the seller regarding a repayment (and therefore the seller would not know when it was entitled to the additional payment).

DECISION IN THE SUPREME COURT

A further appeal was dismissed by the Supreme Court, however the reasoning of the Supreme Court differed from that of the two lower courts.

When did the payment premium 'accrue'?

Lord Reed (with whom Lord Neuberger, Lord Kerr, Lord Toulson and Lord Hodge agreed) held that the payment premium was not "expressed to accrue by reference to the lapse of time" as required by Condition 11.9(a). This finding differed from both the High Court and the Court of Appeal.

Lord Reed stated that the word 'accrue' is used to describe "the coming into being of a right or an obligation". In the case of interest and other payments an entitlement to an amount may accrue even if not actually payable until a future date.

The premium payment accrued on a defined event (prepayment or repayment of the loan). It was irrelevant that the payment premium was calculated by reference to a time period and interest payments.

The court also considered that this interpretation was consistent with the commercial context. The LMA Standard Terms were intended for a market where loans are regularly traded. As such, the Court would not readily infer that the LMA Standard Terms intended to create continuing payment rights and obligations between the parties which might exist over a substantial period of time.

The Court therefore thought that the parties should reflect the potential value of any such payment premium in the purchase price paid for the loan at the time of transfer.

What is the function of Condition 11.9?

Whilst the conclusion in respect of the accrual of the premium payment was sufficient to dispose of the appeal, Lord Reed also went on to consider:

1. whether such a construction of Condition 11.9(a) rendered it redundant, and
2. whether Condition 11.9(a) provided a right to payment, additional to that conferred by the other provisions of Condition 11.

Lord Reed answered no to both these questions.

He noted that Conditions 11.2, 11.3 and 11.4 all excluded from their ambit fees referred to in Condition 11.9(b). Condition 11.9(b) in turn refers to fees other than those described in Condition 11.9(a). Accordingly, he considered that Condition 11.9(a) needed to be read with the other provisions in order to determine the amount of interest and fees to be paid.

He held that despite the difference in the wording in respect of accrual, nothing else suggested that Condition 11.9 was intended to confer an additional right to payment. Instead, it simply allocated interest and fees arising from the obligations to pay in the other Conditions. He held this was supported by the lack of any provision for payment in Condition 11.9 and any provisions addressing the possibility of default by the borrower such as those found in Conditions 11.2(b) and 11.3(c).

COMMERCIAL IMPLICATIONS

This case highlights some of the complexities of the LMA documentation for secondary loan trades. Whilst the LMA Standard Terms contain sophisticated mechanics for allocating loan economics over a broad range of situations, it is always critical to assess whether the specific terms of the loan agreement, and the intentions of the parties, are clearly and appropriately reflected.

Where the LMA Standard Terms do not adequately address the terms of the trade, parties should include additional terms of trade in the trade confirmation to explicitly record their intentions. The *Tael* case is a clear example of a dispute that could have been avoided by way of a clear allocation of entitlement to the premium payment in the additional terms of the trade confirmation. However, care should also be taken to ensure that any such additional terms are clearly drafted and do not introduce additional uncertainty.

Several commentators on the *Tael* case have expressed surprise that a dispute on the terms of a secondary loan trade incorporating the LMA Standard Terms reached the Supreme Court. However, it should be recalled that the LMA suite of secondary loan trading documents is used around the world on a daily basis to carry out a huge volume of trades.

Given the value that is frequently at stake, and the fact that parties often complete the trade documentation without legal input, it could in fact be argued that it is surprising that so few disputes have reached the courts to date. In addition to the treatment of interest and fees, another area fraught with risk is parties introducing purchase price mechanics in the trade confirmation which conflict with the underlying settlement mechanics in the LMA Standard Terms.

Parties should also consider whether the LMA documents are the most appropriate manner in which to document their transaction. In some cases, bespoke legal documents may be more appropriate, either because the complexity of the LMA mechanics is not required, or because the documents being transferred or the trade itself involve concepts or terms that are not readily covered by the LMA framework.

Interestingly, the LMA has indicated that (in contrast to the views of the Supreme Court) it intended Condition 11.9 (now Condition 15.9) to be a 'general sweeper provision' dealing with the allocation of interest and fees between the seller and the buyer, and that as such it should cover additional payment obligations to the extent not otherwise dealt with by the preceding provisions. The LMA has stated it will issue updated documentation to clarify Condition 15.9 so that it achieves this broad effect.

Endnotes

1. It should be noted that the LMA secondary loan trading documentation is regularly updated, and the current documentation differs in various respects from the documentation discussed in this note.

2. As noted above, the LMA Standard Terms have changed since the trade referred to in this note. Under the current LMA Standard Terms (published 3 March 2014), the corresponding provision is Condition 15.9.

KEY CONTACTS

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.

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