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NatWest Derivatives Judgement

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By Tom Grodecki
Partner | Global Litigation

By Nick Shiren
Partner | Capital Markets

By Assia Damianova
Special Counsel | Capital Markets

A recent High Court judgment[1] in a case where NatWest won a claim against CMIS arising under derivative transactions raises several issues of law with practical implications for the structuring of complex finance deals. Notably, the case looked at the distinction between a contact of guarantee and a contract of indemnity and also analysed the question of when a payment is “due".

The Dispute

The dispute centered on deeds (the “Deeds”) granted by CMIS in favour of NatWest in respect of certain swap payments (*i.e.* the Notional Adjustment Payments and Subordinated Step-Up Amounts) that might become payable to NatWest by SPVs established to securitise mortgage loans originated by CMIS (the “EMAC Issuers”). The Deeds provided that CMIS would pay to NatWest “EMAC Indemnifiable Amounts” (defined by reference to those swap payments) as from the date such amounts are due under the swaps. Such “EMAC Indemnifiable Amounts” arose from the periodic adjustment of the swaps, the mark-to-market (MTM) value of which rose from £1.8m in 2016 to £93m in 2017[2].

CMIS argued that the Deeds are guarantees rather than true indemnities and, because the terms of the swaps provided that the payment obligation of the EMAC Issuers to NatWest could be deferred, the EMAC Indemnifiable Amounts were not due or payable by CMIS until such time as the EMAC Issuers’ payment obligation ceased to be deferred.

Guarantee v Indemnity

In construing the Deeds and other securitisation documents together, the court adopted the approach of Lord Clarke in *Rainy Sky v Kookmin Bank* [2011][3] and Lord Hodge in *Wood v Capita Insurance Services Ltd [2017]* [4] where (i) the objective meaning of the language used by the parties has to be ascertained; considering what a reasonable person, who has all the background knowledge which would reasonably have been available to the parties, would have understood the parties to have meant; and (ii) if there are two available constructions, the court is entitled to prefer the construction that is consistent with business common sense that produces the more commercial result.

As the swaps were concluded between 2006 and 2008, the court found a lack of contemporaneous evidence of the commercial intention of parties. However, based on the facts, including that the Deeds were entitled 'Deed of Indemnity', the language used in the Deed was that of “indemnity” and that the obligation to pay EMAC Indemnifiable Amounts was a primary obligation, the court concluded that the Deeds were properly categorised as contracts of indemnity and not contracts of guarantee.

When is a payment “due”?

Having concluded that the Deeds were properly categorised as contracts of indemnity and not guarantees, the court turned to consider whether the EMAC Indemnifiable Amounts were “due” to be paid by CMIS under the Deeds.

This case is an important addition to the existing case-law on the legal effect of Section 2(a)(iii) of the ISDA Master Agreement, which makes payments subject to the condition precedent that no event of default has occurred and is continuing. That case-law draws the distinction between a debt obligation and a payment obligation. Section 2(a)(iii) has been litigated on a number of occasions. The court here considered *Lomas & Ors. v JFB Firth Rixson Inc [2012]* **[5]**, quoting:

"[25] Section 2 of the master agreement is, however, all about the payment obligation and does not, in our view, touch the underlying indebtedness obligation. In particular, section 2(a)(i) obliges each party to make each payment specified in the confirmation and it is that payment obligation which is, by section 2(a)(iii), made subject to the condition precedent that no event of default has occurred and is continuing.

[28] A similar argument to that advanced by Mr. Fisher was submitted to Gloster J. by Mr. Jonathan Crow QC in Pioneer Freight Futures Co. Ltd (in liq) v. TMT Asia Ltd [2011] EWHC 778 (Comm) … a case about FFAs decided after the decision of Briggs J in the present case, at any rate in his oral reply (see [72]). It was rejected by her for much the same reasons as we have set out. She said (at [91]):

"Once one approaches the analysis on the basis that, under section 2(a)(iii), one is only looking at the payment obligation, rather than the debt obligation, the whole machinery makes sense. Thus the wording of section 2(a)(iii) makes it clear that the payment obligation is subject to the condition precedent that no Event of Default or Potential Event of Default has occurred "and is continuing". The natural reading of those words envisages that once a condition precedent is fulfilled, the obligation to pay revives. There is no need for any further creation of the debt obligation itself”

Following the same reasoning, the court concluded that, in the context of the Deeds, the word “due” refers to sums which are accrued due so that there is an existing obligation in debt irrespective of whether payment has been deferred and, therefore, the relevant swap payments were “due” even though the obligation of the EMAC Issuers had been deferred. It therefore followed that the EMAC Indemnifiable Amounts where “due” and had to be paid by CMIS to NatWest under the Deed.

Conclusion

This case is of significance in that it demonstrates:

- that even with well-established principles of interpretation, under long-dated deals concluded many years prior to a dispute, the commercial intention of the parties may not be easily ascertainable;
- the importance of, as far as possible, indicating the commercial context of the documents in recitals and of taking care to record and retain relevant contemporaneous communications relating to complicated structures. This may require exceptions to routine document destruction policies;
- the intention behind certain derivative payments in bespoke deals may be particularly difficult to untangle;
- the choice of title and language of a legal document may be taken into account in interpreting the parties’ intention as to its effect; and
- therefore, the importance of clear drafting when structuring and documenting complex securitisations cannot be overstated.

[1] https://www.bailii.org/ew/cases/EWHC/Comm/2025/37.html

[2] see p.39 of the judgment

[3] 1 WLR 2900 at [14], [21]–[28]

[4] AC 1173 at [8]–[14]

[5] 2 All ER (Comm) 1076