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Fiduciary Duties and Bond Issues

In this talk I am going to consider the role of trustees, and the importance of their duties, specifically in the context of Bond Issues and structured finance. But many of the points that I will make will apply to modern commercial trusts and fiduciary relationships more generally, as well as to bond issues.

The main problem that I wish to discuss today is that of the freedom of parties to waive their fiduciaries' conflicts of interests. The problem is particularly acute, in my view, when the waiver is made in advance, in standard documentation. That arises in the bond issue context, which is why I have taken bond issues as the key example.

My central thesis is that it is time that we looked again at the scope of party autonomy, i.e. the ability of parties to vary the duties that equity would otherwise impose on fiduciaries and trustees. I suggest that equity should do more to control the freedom of parties to define the scope of the duties of fiduciaries and trustees.

In particular, I respectfully suggest that more academic, judicial and practitioner consideration should be given to whether the Court of Appeal decision in Armitage v Nurse [1998] Ch 241 should be reconsidered. For reasons that I shall come onto, that is not as radical a proposition as it sounds. In that case, Lord Justice Millett as he then was, said at p253 that the core, irreducible duties of a trustee (i.e. that could not be excluded or contracted out of) were to act honestly and in good faith for the benefit of the beneficiaries.

In Armitage, the central question was the validity of an exclusion clause in the Trust Deed, exempting the Trustee from liability for gross negligence. That is of course different, being an

exclusion clause, from a duty defining clause, which is what I am particularly concerned with. However, there would be little point in attacking duty-defining clauses if exemption clauses were left untouched: the drafting would change, but the substance would not.

In Armitage Lord Justice Millett explained that it was "far too late" to suggest that an exclusion for ordinary negligence was contrary to public policy. He explained that a trust deed should be interpreted like a contract. He also noted that it was "widely held" that trustee exemption clauses had gone too far, and suggested that Parliament should look at this.

As the Trustee Act 2000 went through Parliament, Lord Goodhart QC queried why no measures were being introduced to control trustee exemption clauses. The Law Commission did a report, and the report eventually came out against it, arguing that light touch regulation was one of the attractions of the London bond market, and that this was helpful to control against vulture funds. The report dates from 2006, when London considered itself fortunate to have so many banks operating from London, and congratulated itself on its wisdom in having light touch regulation.

In my view, vulture funds have a bad press. I have never understood why it is considered unacceptable for there to be secondary trading in debt obligations. Perhaps it has something to do with medieval prejudice against moneylending; I am not sure. But quite what is wrong with secondary trading of the debt part of a capital structure, while secondary trading of the equity part is seen as the bedrock of the financial system, is something that I have never seen properly explained. Nor is it clear to me what is wrong with vultures. They perform a useful clean-up function of carrion in the wild – plagues break out when they are hunted – and a similarly useful function in the financial system. But allowing trustees to be negligent lest vultures flourish seems to me to be case of complete overkill.

So I would agree with what Lord Millett described as "the widely held view" that trustee exemption clauses have gone too far and should be controlled. I think that the professional trustee industry did itself a bad turn when it negotiated for these clauses: it should instead seek

insurance, and pass the cost on as part of their charges. If that insurance is expensive, it suggests that many trustees must be being negligent. This should be a cause for concern.

However, the real mischief comes not so much from exemption clauses (which are potentially bad enough) but from the ability to contract in such a way as to prevent any fiduciary duty arising.

It is has long been said that a Trustee may be a trustee quoad part of his activities and not as regards other parts – New Zealand Netherlands Society "Oranje" Inc v Kuys [1973] WLR 1125; Bristol and West v Mothew. It was also pointed out in that case, rightly, that if a trustee is entitled to prefer his own interests in respect of a particular matter, he is not a fiduciary in respect of it. Where there is a contract between the parties, the scope and nature of the equitable duties owed by the fiduciary or trustee are shaped by the language of those contracts: see, for example, Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services [2012] 1 AC 383.

These three principles, when allied with the principle from Armitage v Nurse that the only duties of a trustee that cannot be contracted out of are to perform the contract honestly and in good faith for the benefit of the beneficiaries, give rise to an extreme situation. The ability of bond trustees or security trustees to contract out of conflicts of interest – thus arguing that their exercise of the powers of enforcement are not fiduciary - leaves many trustees now able to engage in activities that no trustee should be involved in. In practice, the trustee may have very close relationships and commercial interests to prefer the interests of either the borrower, potential owners of the equity, or of some tranches of the debt holders against others. I will come onto a particular example where this was litigated later on, but very often these issues do not dragged into the open; rather, everyone negotiates a restructuring against a backdrop where the Trustee is thought to be partisan.

The theory is wonderfully pure; the practices that it encourages are most certainly not. Given the lack of choice that in practice parties buying bonds have – it is rather too late to seek to

renegotiate the terms at that point - this leaves participants in the market at the mercy of trustees who in practice owe them no meaningful duties, and can manipulate situations to their own advantage. This should be antithetical to a court of equity, and if it is not, I respectfully suggest that something has gone wrong.

So now I come to bond issues and their structure. Those who are finance lawyers will have to bear with me while I set out the basic structure for the non-finance lawyers who are here.

The issuer, i.e. the borrower, typically authorises the managers (a bank) to arrange the issue by a mandate letter. The lead manager finds prospective buyers of the various tranches, which will often carry different rates of interest.

A global bond is issued by the Issuer containing the terms of the bonds. There is normally just one global note which is delivered to a custodian to hold for the clearing systems (Euroclear or Clearstream).

The buyers of the bonds pay the lead manager the money that they are prepared to subscribe, and it then transfers the proceeds of the subscription to the issuer.

Sometimes there is one bond issued to cover many tranches. Even where there is one bond issued per tranche, a global note, that is held by the custodian, all that the bondholders typically get is a beneficial interest in part of that note: the entry in the clearing systems records is thus what establishes the proportions of the beneficial interests for the ultimate investors, and most transactions in bonds are simply shuffling the records as to who holds that equitable interest, from one of the clearing systems' clients to another.

Typically, but not always, there is frequently a bondholder trustee, who holds the entire tranche. The Trust Deed, which is as important as the terms of the notes (if not more so) for determining the rights of the investors, sets out when the Trustee can, and when it must, take action: usually

when instructed so to do by 2/3 of the investors. Normally the bonds will provide that if there has been an event of default, the Trustee can choose from a range of options. It can waive the Event of Default; it can do nothing; or it can accelerate the bonds, and take enforcement action.

Often enforcement action might be way of enforcing security. The issuer will often have given security in the form of its shares in its operating subsidiary. So if the borrower defaults, it can find that its principal, or even sole, revenue stream has been seized, and the Security Trustee (who may or may not be the same as the Bondholder Trustee, if there is one), acting as mortgagee in possession, sells the operating company. A restructuring has effectively taken place. This is one scenario in which the so-called "Loan to Own" strategy frequently arises, whereby someone interested in acquiring a company buys its bonds rather than its shares, with a view to accelerating them and then being able to purchase the company if the company cannot raise the funds to pay off the accelerated debt.

The position gets slightly more complicated if, as is usually the case, there is more than one tranche of bonds. Typically the borrower will issue several tranches of bonds: senior, mezzanine, junior and equity (in descending order of priority, and ascending order of potential return). In such circumstances, the intercreditor agreement is a critical document: it provides who can give instructions to the Security Trustee to accelerate and who can give instructions as to whether and how security should be enforced. (That is typically the Senior Lenders so long as they are unpaid). The underlying justification for this is that the Seniors are supposed to be safest. If the more junior lenders really believe that they are in the money, i.e. the value of the security is sufficient to pay off the debt, they can repay the Senior Lenders in full and will not have lost out.

Legally, where it gets interesting is where you have conflicts between the different classes of beneficiary, and where the Trustee is involved. Conflicts often arise between classes of bondholder. The same problem arises where there are syndicated loans.

Problems often arise where the Security Trustee is in the same corporate group as one of the Senior Lenders. By way of example, in Saltri III v MD Mezzanine [2013] 2 BCLC 217, the Security Trustee was JP Morgan Europe Limited; and JP Morgan Europe Group Limited also acted as the Senior Facilities Agent, and JP Morgan Chase Bank, which owned a slice of the senior debt acted as chair of the Senior Lender Co-ordinating Committee. Far from a Chinese wall being put in place, the same individuals, wearing different hats, acted both as Security Trustee (for the Senior and Mezzanine Debt) and chaired the Senior Lender Co-ordinating Committee. It is perhaps not wholly surprising that when the Senior Lenders instructed the Security Trustee (that would be the same team at JP Morgan telling each other what to do) that the Mezzanine Debt had no value, so that the operating company should be sold to a purchaser who granted the Senior Lenders PPLs in the purchaser, the Mezzanine Lenders cried foul and sued. PPLs are a magic form of instrument, much beloved of structured financiers for their tax treatment – they are debt instruments that behave like equity, which in some jurisdictions are treated like debt and in others are treated like equity, as they really are. The clue is in the name: Profit Performing Loans. The profit element is variable, very much like equity.

In MD Mezzanine the sale was for a grand total of €4, because the company was bought subject to its debt, in return for the senior lenders obtaining the PPLs.

The decision of the Commercial Court was that because – as is well known, and as was common ground in the case – a mortgagee's power of sale is not fiduciary, it was not a problem that JPMEL, the Security Trustee, was also in the Senior Debt. The Court said that it is no problem for someone to be a fiduciary quoad part of their obligations and not as regards others; and there was a built in conflict of interest in the case, regulated by the Intercreditor Agreement, that provided that before they were paid off, the senior lenders had the right to direct enforcement: see para 124. Eder J held that as it was essential for a mortgagor challenging a mortgagee-in-possession's sale to prove loss, it was essential for the Mezzanine Creditors to prove loss, which they could not. It was JP Morgan's own evidence in the case that its Special Credits Group had worked with the Senior Lenders because "we", i.e. JPM, were in the Senior Debt.

The case really serves to highlight the importance of the terms of the intercreditor. JP Morgan made much of the point that their fiduciary duties were limited by the contractual terms – which the Court accepted. This is far from the only case that I have seen where the Security Trustee, or the Bondholder Trustee, has acted in a way which favours one group of lenders at the expense of another, or has refused to share information with one group of beneficiaries (relying on the letter of wishes cases). There is good article by Professor Hooley in the Journal of Business Law from 2012 which sings the praises of this approach, saying that it is all a matter of freedom of contract.

But I am not sure that this is quite the complete answer that it appears to be. Where someone is appointed to a fiduciary role, can the role be defined away so that the no-conflict rule is simply inapplicable? I would suggest not.

The approach of the courts to the freedom of parties to vary the contents of fiduciaries' duties should mirror the court's attitude towards freedom of contract generally. In contract law, as every student knows, the approach to freedom of contract over time has a pendulum like swing to it. In the 1930s, it reached a highpoint, both in the US under the Lochner-era Supreme Court that is widely taken to have ended in 1937. As in many fashions, the UK, and its then dominions and colonies, took their time to follow American fashion, and followed suit with such cases as Canada Steamship in the 1950s. The world swung away from untrammelled classical freedom of contract, recognising that all too often the reality was that there was no freedom at all, because there is not much freedom to negotiate the terms of a MTR ticket: they are take it or leave it. The politicians then caught up even later, bringing in statutory curbs on freedom of contract.

But in certain sorts of contract, it is well recognised that parties cannot simply make their own rules: particularly when these contracts are often assigned, and there are public interests in the duties that they impose. The most obvious, and I suggest highly pertinent example, would be the contract between the members of a company to be found in its articles of association. That contract, like the contracts between bondholders which I will come onto in a moment, has a wider public interest. The members of company are not free to agree whatever they like as

regards exempting the duties of directors: there are limits. Most obviously, the Companies Acts in most common law jurisdictions contain restrictions on the validity of transactions between directors and the company: see, in England, section 41 of the Companies Act.

Our current concepts as lawyers of the capital structure of a company may be due a rethink. There is a read across between the positions of shareholders and bondholders, in my view. A corporate financier would not recognise the different financial interests of the company as being so very different; hence, indeed, the fact that the junior tranche of debt, often deeply out of the money, is described as the equity tranche; and similarly the way that the provision of deeply subordinated debt is often permitted in finance documents as an "equity cure". Perhaps it is time for shareholder protections to be considered necessary for bondholders as against their trustees.

There are precedents for considering the position of shareholders, when looking at bondholders. Bond agreements, like the articles of a company, often contain provisions for waivers to be made on majority votes; there are meetings of bondholders, on notice, and different majorities are needed to pass different sorts of amendments to the loan terms, if they are to bind all bondholders, including those voting against. In Redwood Master Fund v TD Europe Ltd [2006] 1 BCLC 149, the "fraud on the minority" parallel with company law was effectively imported into bond issues in relation to such votes.

And in the Irish Bank resolution case – [2012] EWHC 2090 – Briggs J held that where an issuer of bonds had made an offer to bondholders who accepted terms to buy their bonds, provided that they voted to wipe out the value of dissenting bondholders, it was unlawful for the majority to cast their votes so as to coerce the minority; that was "oppressive and unfairly prejudicial".

In the latest edition of his seminal work *Fiduciary Obligations,* Paul Finn discusses relatively modern cases in Australia. He doesn't like some recent Australian decisions, such as Australian Securities & Investments Commission v Citigroup [2007] 160 FCR 35. He deplores contracting out. In my view, this must be right. Applying the Street v Mountford principle, there is

something very wrong with describing someone as a fiduciary or a trustee, but allowing them to have conflicts of interest that are really fundamental. At the very least, there should be a presumption to construe such contracting out narrowly. When someone contracts to have a bank act as Trustee, they are not envisaging that the trustee may itself (through its affiliates) take a slice of a different part of the capital structure. This just should not be tolerated. As Finn said in his judgment in South Sydney District Rugby League Football Club v News Ltd [2000] FCA 541, whatever artful disclaimers are put on the on the relationship, the Court should look at the reality of the relationship, and impose on that reality the obligations that flow with it.

We all lose out when banks are free to game the system: including, ultimately, the banks. The Issuer of bonds in practice has a lot of say over the choice of the trustee. A world where the Issuer chooses a bank that it thinks will lean towards it, rather than to the bondholders is not a good one. A world in which a neutral bank is chosen, but the bank then decides to get involved when a restructuring appears on the horizon, is similarly ultimately not healthy. I am sure the LMA and others would jealously guard their own standard documentation. If they do not act, I suggest that the Courts should apply the doctrine that parties are free to define the terms of their relationship less readily than they do at present. Otherwise, the word trustee may become so devoid of content that it can be misleading.

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