KEY POINTS

- Trustee exemption clauses, and clauses that prevent fiduciary obligations regarding conflicts of interests, should be subject to statutory control.
- It is particularly important that affiliates of security trustees or bond trustees should not be involved in the capital structure.

Feature

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Excluding fiduciary duties: how far should trustees be able to go? Lessons from bond issues

This article considers the role of trustees, and the importance of their duties, specifically in the context of bond issues and structured finance.

Security and bond trustees, or their affiliates, often have interests in the Issuer's debt or equity. This is problematic and can give rise to what would be breaches of fiduciary duty, but for duty defining clauses and exemption clauses. The policy question is: how free should parties be to waive their fiduciaries' conflicts of interests? Waivers are particularly problematic when made in advance, in standard documentation, in respect of tradeable interests: bonds and loan participations. These clauses should be subject to greater statutory and judicial control.

Is it time that we looked again at the scope of party autonomy, ie the ability of parties to vary the duties that equity would otherwise impose on fiduciaries and trustees? Elspeth Talbot-Rice QC and Timothy Sherwin called for more control of exemption clauses in these pages in the March 2018 edition ((2018) 3 JIBFL 154). I agree and 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. That is not as radical a proposition as it sounds. In *Armitage*, Lord Justice Millett as he then was, said at p 253 that the core, irreducible duties of a trustee (ie 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 this article is 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 exemption clauses were helpful to control 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.

I do not think that protecting trustees from bondholders, be they vulture funds or other funds, can possibly justify these clauses. In my view, vulture funds have an unjustified bad press. People seem to consider that it is unacceptable to buy bonds at a discount and be paid in full. That is an inevitable feature of secondary trading of debt obligations. 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. Perhaps the root of the objection has something to do with medieval prejudice against moneylending; I am not sure. 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 similar clean-up function in the financial system. But even if vultures do need to be controlled, this seems a thin rationale for allowing trustees to be negligent or to contract out of conflicts of interest.

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.

In my view 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 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* [1998] Ch 1. 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. Very often these issues do not get dragged into the open; rather, everyone negotiates a restructuring against a backdrop where the Trustee is thought to be partisan.

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 – participants in the market are at the mercy of trustees who can in practice owe them no meaningful duties, and can, if they so choose, 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.

THE STRUCTURE OF BOND ISSUES

The issuer, ie 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: frequently it is 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 by 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, ie 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.

TRUSTEE INVOLVEMENT IN RESTRUCTURING

In a restructuring, conflicts often arise between classes of bondholder.

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 (JPMEL); 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.

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 profit performing loans (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, as the profit element is variable.)

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

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challenging a mortgagee-in-possession's sale to prove loss, it was essential for the Mezzanine Creditors to prove loss, which they could not.

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 one group of bondholders considers favours a different tranche; or where the Trustee has refused to share information with one group of beneficiaries (relying on the letter of wishes cases). Indeed, I understand that one of the first questions prospective investors ask is: "Who is the Trustee at the moment? What tranche are they in?".

The advocates of the status quo say 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 FREEDOM OF CONTRACT/ JUDICIAL CONTROL CYCLE

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 train 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 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, has a wider public interest. The members of a 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, s 41 of the Companies Act.

A PARALLEL WITH SHAREHOLDERS?

The way that lawyers classify the capital structure of a company may be due a rethink. There is a read across between the positions of shareholders and bondholders. A corporate financier would not recognise the different financial interests in the company as being so very different in nature; hence, indeed, the fact that the junior tranche of debt, often deeply out of the money, is described as the equity tranche. Similarly, where finance documents permit an "equity cure" for a breach of covenant, the documents often provide for the "equity" to be deeply subordinated debt or equity. 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. Again, in the *Assénagon v 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".

SUPPORT FROM DOWN UNDER

In the latest edition of his seminal work *Fiduciary Obligations*, Paul Finn discusses relatively modern cases in Australia. He criticises 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 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 relationship, the court should look at the reality of the relationship and impose on that reality the obligations that flow with it.

CONCLUSION

We all lose out when trustees' privileges become so great that they are free to game the system: including, ultimately, the trustees. 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. It will not be easy to change standard documentation. If it does not change, 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. ■

Further Reading:

- The role of the security trustee: lessons from the Stabilus restructuring (2013) 4 JIBFL 201.
- Time for change: trustees' liability for negligent investment in offshore portfolio bonds (2018) 3 JIBFL 154.
- LexisNexis Loan Ranger blog: Spotlight on trustees: how have they adapted to recent "streamlined" documentation provisions?