Trust Me – A Security Trustee's Duties to Subordinated Creditors Examined

A recent High Court judgment has highlighted the importance for mezzanine creditors of including express and robust contractual protections when negotiating intercreditor agreements and provides a helpful summary of a trustee's duties to mezzanine lenders when enforcing security.

The recent judgment of *Saltri III Ltd v MD Mezzanine S.A. Sicar & Ors*[1] relates to the 2010 non-consensual restructuring of the Stabilus Group. The judgment provides a helpful overview of the way fiduciary relationships operate in a secured financing and the effect of provisions allowing duties that would otherwise arise to be departed from by contract.

The Court considered:

- The "purpose" of an intercreditor agreement.
- The fiduciary and non-fiduciary nature of the security trustee's obligations to the mezzanine lenders.
- The extent of the security trustee's duties to carry out a marketing and sale process or other bidding process, or to take expert advice to make the sale a success.
- The treatment of realisations made for non-cash / nominal consideration.

Facts

When the Stabilus Group was acquired in 2008 by a private equity fund, companies in the group incurred indebtedness under English law governed senior and mezzanine loan agreements and granted security over their assets.

The relative rights of the senior and mezzanine lenders were governed by an intercreditor agreement that included fairly typical market terms.

The group got into financial difficulties and in 2010 the security trustee, on the instructions of the facility agent (which was the same legal entity as the security trustee and had been, in turn, instructed by 100% of the senior lenders), enforced the transaction security. The security trustee transferred the group to a new holding company owned by one of the senior lenders. The mezzanine lenders received nothing. The mezzanine lenders challenged the validity of the restructuring and brought claims alleging breaches of duty against the security trustee.

Improper Purpose?

An argument advanced by the mezzanine lenders was that the intercreditor agreement could not be used for the purposes of a restructuring at all, or at least a non-consensual one, and that the restructuring was therefore void. The Court rejected this on the basis of the following:

- The Court does not look at the "purpose" of an agreement but instead interprets the provisions and establishes whether there has been a breach.
- The mezzanine lenders were wrong to argue that the intercreditor agreement was not designed to allow a non-consensual restructuring on the basis that out-of-the-money mezzanine lenders have a bargaining position.
- It was clear that the intercreditor agreement had been used in past cases to effect non-consensual restructurings. In the European Directories and Bluebrook cases a restructuring took place involving steps under an intercreditor agreement.

[1] [2012] All ER (D) 93 (Nov)

Duty of a Security Trustee as a Fiduciary

The Court considered whether the security trustee had breached Clause 14 (which obliged the security trustee to enforce the security when instructed by the senior lenders) and Clause 15 (which gave the security trustee the power to release assets from the security before and after enforcement) of the intercreditor agreement.

In considering these issues, the judge summarised the following legal principles relating to the manner in which fiduciary relationships shape duties:

- A fiduciary might be in a fiduciary position in respect of a part of his activities and not in respect of other parts. Each function had to be looked at separately.
- Those fiduciary duties could be contractually modified so that where sophisticated parties enter into arms-length commercial contracts, the scope and nature of the duties owed between the parties are shaped by the terms of the contract.

The Court then applied these principles to the issue of the security trustee's obligations as a fiduciary in relation to enforcement. It rejected the argument that the security trustee had been obliged to act in the interests of all the lenders when enforcing the security for the following reasons:

- According to Clause 14.3 of the intercreditor agreement, the duty of the security trustee to the mezzanine lenders in relation to a sale was "*no different to or greater than the duty to the Obligors that would be owed by the Security Trustee, Receiver or Delegate under general law*". These words were interpreted by the judge to mean that the duty was equivalent to the duty of a mortgagee to a mortgagor. This clause governed the relationship of the security trustee and the mezzanine lenders in respect of the former's duty on enforcement of the security.
- The intercreditor agreement subordinated the interests of the mezzanine lenders to those of the senior lenders.
- The senior lenders were given the right to control the timing and manner of enforcement. The security trustee was obliged to follow the instructions of the senior lenders even though the manner of enforcement was detrimental to the interests of the mezzanine lenders.

Conflict of Interest between the senior and mezzanine lenders

The mezzanine lenders contended, among other things, that in relation to enforcement, the security trustee was a fiduciary and was therefore obliged to act in the interests of all the lenders.

Referring again to Clause 14.3, the Court held that a mortgagee has no duty to avoid a conflict of interest with the mortgagor. Their interests diverge and there is therefore a built-in conflict. Instead, the only constraints on a mortgagee's power of sale are:

- Not to sell the secured property to itself.
- To obtain the best price reasonably obtainable at the time.
- To exercise its power bona fide and for a proper purpose.

Valuation and the Sales and Marketing Process

It was common ground that the security trustee was at least under a duty to (a) take reasonable care to obtain the true value of and/or the best price reasonably obtainable for the security at the time of sale, and (b) exercise the power of sale bona fide and for its proper purpose.

The mezzanine lenders invited the court to go further by requiring the security trustee to take expert advice as to the method of sale and as to the steps which ought reasonably to be taken to make the sale a success.

The Court declined the invitation on the following basis:

- There is no absolute obligation to carry out a marketing and sale process or other bidding process, or to take further independent advice on how to achieve success in the sale.
- On the contrary, the Court pointed to deliberate judicial resistance to laying down prescribed procedures or processes which a mortgagee must follow.
- The decision as to whether the security trustee had taken reasonable steps to obtain the best price was a commercial one, to be viewed through the prism of commercial reality.
- The nature of the underlying assets is one factor of the commercial reality. In this case it was a huge global business operation and not a single piece of real property. Another factor was that the company was on the brink of insolvency.
- The security trustee would not be in default of its duties unless he was "*plainly on the wrong side of the line*".
- The burden of proof in relation to breaches of duty was on the security trustee to prove to the contrary.

The Court held that, on the facts, and despite conducting only a "desktop" valuation, the security trustee had done enough to discharge its duties. Parallels were drawn with the Bluebrook case. There, as in the present case, the financial advisers conducted a limited exercise which was not taken beyond the indicative bid stage. In that case, the Court also accepted that the process run by the financial advisers was useful in that it assisted in pointing to a value well below the senior debt.

The fact the restructuring proposals advanced by the mezzanine lenders themselves indicated that they were "out of the money" weighed heavily on the judge's mind. As the judge put it, "*there was no reasonable or realistic basis for supposing that any purchaser would come forward with a cash or equivalent bid within a measurable distance of the Senior Liabilities*".

Even if the mezzanine lenders had been successful in establishing liability, the Court held that there was no actionable breach of duty by the security trustee as it was overwhelmingly likely that a full marketing and sales process would not have obtained a price in excess of the senior liabilities. The mezzanine lenders had suffered no loss.

Differing Roles of the Security Trustee

The mezzanine lenders contended that there was no separation internally with respect to the sharing of information and advice between the security trustee and the affiliated senior lender in that no information barriers were put in place. Although they were separate companies, the lines demarcating the different roles of personnel within the group were unclear.

The Court found that the necessary information barriers were not put in place but that this did not cause relevant loss to the mezzanine lenders.

Non-cash / nominal consideration

The mezzanine lenders argued that realisations upon enforcement had to be paid in cash and allocated in accordance with the post-enforcement waterfall. The issue of non-cash / nominal consideration was not addressed in the intercreditor agreement. The Court rejected the argument advanced by the mezzanine lenders that only cash consideration should be distributed and held:

- Realisations upon enforcement could be made for non-cash consideration or nominal consideration despite the intercreditor agreement not expressly addressing this issue. The intercreditor agreement release provisions referred to "proceeds", and other provisions made reference to "amounts…received or recovered" and "payments". The Court considered that these are all apt to refer to non-cash as well as cash consideration and that there is no reason why non-cash consideration cannot

be allocated in accordance with the waterfall in the intercreditor agreement.

- The Court made it clear that if the parties wish to preclude realisations being made for non-cash / nominal consideration, this would need to be expressly provided for in the intercreditor agreement as the prohibition would be "uncommercial" and would be a "significant fetter on the Security Trustee's powers".

It is worth noting that the September 2012 changes to the LMA form of intercreditor agreement introduced provisions that expressly enable the security trustee to receive non-cash consideration. The provisions include a proviso that an independent financial advisor will determine the value of the non-cash consideration and the discharge of liabilities resulting from a distribution of non-cash consideration to lenders, although they leave the choice of adviser within the control of the senior lenders. The senior lenders also control the power to instruct the security trustee as to whether to accept non-cash consideration or realise it for cash prior to distribution to lenders.

Claims Dismissed

In brief, the Court held that the security trustee had not breached Clauses 14 or 15 of the intercreditor agreement or any fiduciary duties. The claims advanced by the mezzanine defendants against the security trustee were dismissed, the restructuring was declared valid and it was held that there had been no breach of fiduciary or contractual duties by the security trustee. Permission to appeal to the Court of Appeal has been granted.

Comment

The case provides a stark reminder of the consequences of relying on the weak contractual terms of older style intercreditor agreements and reinforces the need for mezzanine lenders to protect their rights as stakeholders by negotiating robust contractual protections up front. Although an increasingly assertive mezzanine constituency has made significant strides towards improving its position, we expect valuation criteria and conditions to distressed disposals to continue to dominate negotiations between senior and mezzanine lenders. Arguably as important, the case highlights the need for information rights to be expressly agreed in order to allow the mezzanine to compete in any sales process. It may be that this judgment will encourage mezzanine lenders to seek more express rights, including the ability to engage independent legal counsel and expert professional advisers.

The case is also a reminder to banks that they need to be aware of conflicts of interest that can occur when the bank acts as security trustee and lender, and that appropriate processes to manage potential conflicts have to be put in place and observed.

If you would like to learn more about the issues in this alert, please contact your usual Ropes & Gray attorney, or any of the attorneys listed below.

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