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English High Court Rules on Security Trustee's Duties to Mezzanine Lenders on Enforcement of Security

The High Court has recently held that a security trustee under an intercreditor agreement owed duties to mezzanine lenders that are equivalent to those owed by a mortgagee to a mortgagor, which were not fiduciary duties. The detailed judgment contains many other points of considerable interest to security trustees and to the wider leveraged finance market.

Lessons

Some important lessons can be drawn from the recent judgment of Mr. Justice Eder in Saltri III Ltd v MD Mezzanine S.A. Sicar & Ors [2012] EWHC 3025 (Comm).

- Lenders and security trustees, where they are part of the same group should, at all times, maintain proper separation both in terms of personnel and document access. In the case of financial institutions with specialised trustee departments or subsidiaries, it is probably already the case but systems and procedures should be checked in any event. For financial institutions with no such specialist department or subsidiaries, particular care should be taken to put in place appropriate procedures to segregate personnel and information to avoid not only the criticisms of Mr. Justice Eder, but also the liability he refers to. It is to be remembered that the reason given for there being no actionable breach was that the mezzanine lenders suffered no loss. It would have been interesting to see what the position would have been had they in fact suffered loss.
- In the enforcement of security the security trustee's position is not that of a fiduciary.
- It should not be assumed that just because the senior lenders give an instruction to the security trustee that it can or should act without reference to the interests of junior lenders in all circumstances.
- The burden of proof in relation to breaches of duty is on the security trustee to prove to the contrary.
- Security trustees should be mindful when giving information to one class of lenders without giving the same to the other classes.
- Special care should be taken in relation to legal advice provided to security trustees so as to differentiate between legal advice given in respect of the performance of their duties (which is unlikely to attract legal privilege and is thus disclosable at trial) and advice taken in contemplation or under the threat of litigation (which is likely to be privileged and not capable of disclosure).

- Due consideration should always be given as to the nature of legal and financial advice and the independence of such advisors from other transaction parties at an early stage to avoid some of the conflicts of interests noted in the judgment which arose during the restructuring process.

Background

In Saltri III Ltd v MD Mezzanine S.A. Sicar & Ors [2012] EWHC 3025 (Comm) the High Court was asked to consider the liability of a security trustee in enforcing security as part of a non-consensual restructuring of a leveraged finance transaction for the Stabilus Group. The original transaction was a fairly classic leveraged financing with a senior loan and mezzanine loan with the inter-relationship between the relevant lenders governed by an intercreditor agreement ("**ICA**"). The loans and ICA were governed by English law. Various members of the Stabilus Group provided guarantees and security interests. From the transcript of the judgment, it is clear that the documents were, in the main, very much in an LMA format.

The company got into financial difficulties and, in summary, 100% of the senior lenders instructed the security trustee, via the senior facility agent (which was the same legal entity as the security trustee) to enforce the transaction security and transfer the business of the Stabilus Group to third parties leaving, effectively, no assets for the mezzanine lenders to have recourse to.

The mezzanine lenders commenced proceedings against the security trustee alleging breaches of duty under certain provisions of the ICA and, more widely, breach of fiduciary duty. It is worth noting that no allegation of breach of duty was made against the senior lenders themselves, nor of bad faith against any party.

The judgment is long and goes into an interesting and highly forensic analysis of the transaction documentation, the restructuring process and the rights, duties and actions of the various parties involved. As such, the judgment goes beyond merely answering the two main issues outlined above and, whilst some of the statements might be considered obiter, provides useful, and in some cases very candid, views as to what went on during the restructuring process and the law regarding fiduciary duties generally.

Mr. Justice Eder ruled, in any event, that the security trustee was not liable under either of the heads pleaded by the mezzanine lenders.

Points to Note

- Significant parts of the judgment are fact specific but from them can be extrapolated some broader principles.
- Restructuring proposals put forward by the mezzanine lenders clearly showed that they were "out of the money". That position remained the case under various valuations provided during the restructuring process.
- Whilst one of the senior lenders and the security trustee were different companies within the same banking group, there was no internal separation as to the persons receiving advice and documents on behalf of the senior lenders and security trustee, respectively. No Chinese walls were set up and the same people often acted on both sides. Indeed some of the personnel involved seemed to act at various times for either or both the senior lender and security trustee. This included the receipt of various pieces of information and documentation, some of which was not shared with the mezzanine lenders.
- The mezzanine lenders attempted to argue that an intercreditor agreement cannot be used for the purposes of a restructuring at all, or at least a non-consensual one. This was rejected on the basis that it is not for the court to ask in general terms what an agreement is designed for; merely to interpret the contract in accordance with well established

principles. Mr. Justice Eder also rejected the suggestion that the mezzanine lenders had a bargaining position notwithstanding how far out of the money their debt was.

- The contention that any realisation of the enforcement of security was required to be paid in cash and then paid down the post-enforcement payment waterfall was rejected. The terms of the ICA nowhere prevented a sale or disposal from being made for nominal consideration or non-cash consideration. The judge was very clear that if this had been intended to be a requirement it should have been expressly stated as such in the ICA. He observed that it would be a very un-commercial position to, for example, require a security trustee to accept a cash bid of £50million free of all debt whilst being unable to accept a bid to purchase the equity for nominal consideration subject to retaining £150million of existing debt.
- Simply because a security trustee is a fiduciary in some respects does not make it a fiduciary in all respects. The court has to consider each particular duty alleged to be breached. In this particular case the relevant duties were concerned with enforcement and the ICA largely set out the scope and nature of those duties. The mezzanine lenders argued that in relation to the enforcement of security the security trustee was a fiduciary which Mr. Justice Eder described as "fundamentally wrong". This was because: (i) the ICA subordinated the interests of the mezzanine lenders to those of the senior lenders; (ii) the senior lenders were given the right to control the timing and manner of enforcement which right is binding on the mezzanine lenders and the security trustee is obliged to follow these instructed (subject to any restrictions imposed by the ICA, of which there appeared to be none); (iii) the provisions dealing with the release of security on sale or transfer in the ICA may be exercised contrary to the wishes of the mezzanine lenders; and (iv) the ICA expressly stated that the only duty of the security trustee to the mezzanine lenders in relation to a sale is that of mortgagee to mortgagor which is not a fiduciary duty.
- An argument that the security trustee, as a fiduciary, was in a position of conflict with the senior lender (because they were part of the same banking group) was stated by the judge to be "flawed in law". This is on the basis that a person may be a fiduciary in respect of some of its functions and not others. Because a security trustee's only duties in respect of the enforcement of security were those of a mortgagee and there is no duty on a mortgagee to avoid a conflict of interest with any mortgagor (there is always a built-in conflict because their interests diverge). The controls on a mortgagee's powers under English law do not include the requirement to avoid a conflict between itself and the mortgagor which the judge described as "an impossible requirement". English law merely consists of the requirement of the mortgagee not to sell to itself and the duty of care to obtain a proper price and that the power be exercised bona fide for proper purposes.
- There is a "heavy burden" on the security trustee to show that, at the very least, it had acted fairly and exercised reasonable care to obtain the best price reasonably obtainable. In deciding whether reasonable steps have been taken to obtain the best price the scenario has to be looked at in the round and in practical commercial terms.
- In the absence of proof of any loss as a result of the security trustee's actions there can be no actionable breach of duty.
- In considering whether a security trustee was in breach of any such obligation one has to take account of the nature of the underlying assets which, in this case, were not a single piece of real property but a global business operation which was, at the time of the restructuring, on the brink of insolvency.

- The lack of proper Chinese walls and the decision to share information with one or more senior lenders to the exclusion of the mezzanine lenders likely constituted a breach of the security trustee's duties. However, since there was no evidence that this was causative of any loss, no liability fell on the security trustee.

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