BONDS AND BOND TRUSTS

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ABSTRACT

Most corporate bonds are issued under a trust structure. Under a bond trust, the issuer appoints a trustee to act on behalf of the bondholders. This thesis aims to provide a comparative overview of the law of bond trusts in a number of major jurisdictions, and offer some valuable insights into various aspects of the tripartite relationship involving the issuer, the bond trustee, and the bondholders.

In particular, this thesis looks at four specific issues. First, this thesis looks into the bond trust regime under New Zealand law and argues that the monitoring duties imposed on bond trustees are too onerous and therefore unlikely to achieve their purposes.

Secondly, this thesis analyses the legal nature of the bond trust, and argues that it is fundamentally different from other types of express trust. Accordingly, the trustee's duties and liabilities should be analysed under a contractual framework in accordance with the presumed intention of the parties.

The third issue discussed is the no-action clause contained in standard bond trust deeds. The no-action clause provides that bondholders may not proceed against an issuer unless certain conditions are met. The thesis compares two approaches in interpreting this clause, the expansive approach and the restrictive approach, and argues that the former should be preferred.

Finally, this thesis turns to exit consents. The exit consent technique refers to an offer by a bond issuer to all the bondholders to exchange the existing bonds for new bonds or other types of securities, on the condition that the tendering bondholders must consent to a resolution which will amend the terms of the existing bonds so as to make the bonds less attractive. It is submitted that the exit consent does not violate s 316(b) of the Trust Indenture Act of 1939 (US), nor the abuse principle under English law.

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CHAPTER 1 INTRODUCTION

1.1 Preliminary

> "Of all the exploits of Equity the largest and the most important is the invention and development of the Trust… This perhaps forms the most distinctive achievement of English lawyers. It seems to us almost essential to civilization, and yet there is nothing quite like it in foreign law."[1]

Capital markets play an important role in promoting local and global economic activities. One key component of capital markets is the debt securities market. In practice, various terms, such as bonds, notes, and debentures, are used to describe debt securities.[2] In this thesis, the terms "bond" and "note" will be used throughout as generic descriptive terms of debt securities, unless the context demands otherwise.

Issuers of bonds include central governments, government agencies, municipal authorities, international organisations, financial institutions and non-financial corporates. Most non-financial corporate bonds are issued under a trust structure.[3] Under a bond trust, the

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1 Frederic William Maitland *Equity, Also The Forms of Action at Common Law: Two Courses of Lectures* (Cambridge University Press, Cambridge, 1909) at 23.

2 The terms "bond" and "note" are not defined in law. In commercial practice, debt securities with a maturity of one to five years or at a floating rate are called notes, whereas debt securities with a fixed rate or more than five-year maturity are called bonds. Debt securities with less than one year tenor (usually not more than 270 days) are called commercial papers. Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd ed, Sweet & Maxwell, London, 2007) at 193. In contrast, "debenture" does have a statutory definition in a number of countries. See for example s 738 of the Companies Act 2006 (UK); s 9 of the Corporations Act 2001(Cth). In the United Kingdom, Australia and New Zealand, in commercial contexts the term "debenture" normally refers to secured debt securities, whereas in the United States, "debenture" normally refers to unsecured debt securities backed solely by the general credit of the issuer. See George E Palmer "Trusteeship under the Trust Indenture" (1941) 41 Colum L Rev 193 at 194.

3 Under the laws in certain jurisdictions, such the United States, Canada, New Zealand, Australia and Singapore, a trustee must be appointed for the bonds issued to the public. Under English law, there is no statutory requirement for the appointment of a trustee, although in practice a trustee is appointed in almost every issue of corporate bonds. See Philip Wood *Law and Practice of International Finance* (Sweet &

bond trustee holds the chose in action and other covenants granted by the bond issuer on trust for the benefit of the bondholders. In terms of secured bonds, the bond trustee will usually be appointed as security trustee, holding the security interest on trust for the bondholders.[4]

Bond trustees provide important services to bondholders and play an indispensable infrastructure role for the smooth running of the bond markets. Generally speaking, prior to default, the duty of the bond trustee is primarily administrative. After default, however, the role of the bond trustee becomes crucial, as it will take actions on behalf of the bondholders against the issuer. Such actions may include legal proceedings.[5]

The laws of bonds and bond trusts can be broadly divided into two categories. The first category regulates the offering of bonds. In particular, in terms of publicly issued bonds, the issuer is required to disclose certain financial and other information. The second category regulates the tripartite relationship among the issuer, the bondholders, and the bond trustee. Legal issues in the second category include the issuer's duties owed to the trustee, the trustee's duties and powers, and the bondholders' rights against the issuer. This thesis focuses on the laws concerning the second category.

Maxwell, London, 2008) at [12.27]. In terms of listed bonds, the applicable listing rules may also require a trustee to be appointed.

4 In the early days, virtually all corporate bonds were secured over certain property of the issuer. A trust structure was adopted in bond transactions to facilitate the transfer of bonds without the need to transfer the security interest. Gradually a trust structure was adopted even where the bonds were not secured because of the useful functions performed by the trustee. Richard B Smith, Stephen H Case and Francis J Morison "The Trust Indenture Act of 1939 Needs No Conflict of Interest Revision" (1979) 35 The Business Lawyer 161 at 163–164.

5 For a detailed description of the role of a bond trustee, see Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 17–21.

1.2 Literature review

The legal issues involved in a bond trust structure can be complicated. Various areas of law may come into play, such as contract law, equity, torts, regulatory, tax and, in terms of international bonds, conflict of laws. Generally speaking, domestic bonds are governed by the relevant local law, whereas international bonds are mostly governed by English law or US law.

1.2.1 Literature on bond trusts governed by English law

The topics of bond trusts in general and, in particular, the duties of bond trustees have, with a few exceptions, attracted scant critical attention from the legal academic community when compared with other areas of financial activity where equitable concepts have intruded.[6] This is probably due to a lack of case law. In recent years, however, a combination of the increased number of bond defaults and the emergence of bondholder activism has resulted in a marked increase in judicial consideration of bond trusts.[7] There exists now a small body of academic literature on certain specific legal issues in a bond trust structure, including the scope

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6 A search of the term "bond trust" at Thomson Reuters Westlaw database under section "United Kingdom" returns a mere 13 journal hits, whilst a search of the term "family trust" returns 250 journal hits (both searches conducted on 15 January 2017).

7 See for example *Re Colt Telecom Group plc* [2002] EWHC 2815 (Ch); *Concord Trust v Law Debenture Trust Corp plc* [2005] UKHL 27; *Citibank NA v QVT Financial LP* [2007] EWCA Civ 11; *Re Sigma Finance Corp (in admin rec)* [2009] UKSC 2; *Elektrim SA v Vivendi Holdings 1 Corp* [2008] EWCA Civ 1178; *Law Debenture Trust Corp plc v Elektrim SA* [2010] EWCA Civ 1142; *Assenagon Asset Management SA v Irish Bank Resolution Corp Ltd (formally Anglo Irish Bank Corp Ltd)* [2012] EWHC 2090 (Ch); *Azevedo v IMCOPA – Importacao, Exportaacao e Industria de Oleos Ltda* [2013] EWCA Civ 364; *BNY Mellon Corporate Trustee Services Ltd v Taberna Europe CDO I plc* [2016] EWHC 781(Ch).

of the bond trustee's duties,[8] collective action clauses,[9] and exit consents and consent payments.[10] In general, however, academic research on bond trusts is still lacking. One notable exception is the work produced by Philip Rawlings.[11]

Drawing insights from recent case law, Rawlings systematically discussed the changing dynamics of the relationship between the bondholders and bond trustees in a series of three articles. He observed that the bond trustee was now under increasing pressure from the bondholders and its exercise of discretion might be open to review. Traditionally, while legally speaking the bond trustee owes fiduciary obligations to the bondholders, its role in the bond markets has a certain degree of neutrality – it serves as a bridge or referee between the issuer and the bondholders. This contradiction is less problematic under benign market conditions where bond defaults are rare.[12] In recent years, however, two market changes have brought the bond trustee's role under the spotlight. The first change is the emergence of junk bonds which,

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8 See for example Alexander Trukhtanov "The Irreducible Core of Trust Obligations" (2007) 123 LQR 342; Esther Cavett "When the Music Starts Again: How Should Trustees Conduct Themselves in the New World?" (2010) 25 JIBFL 469; Helen M Dervan "Reviewing the Citibank Securitisation Case: Did it Really Challenge the Integrity of Equity?" (2016) 27 JBFLP 279.

9 See for example Josephine Carr "One Lesson to Be Learnt From Dome Petroleum" (1987) 6 IFLR 15; Stephen Moverley Smith "Challenges to Collective Action Clauses" (2012) 8 JIBFL 479.

10 See for example Stephen Moverley Smith and Harry Sharpe "An Offer You Can't Refuse: When Does Coercion of a Group to Accept a Proposal Constitute Oppression of the Minority?" (2014) 29 JIBFL 288; Keegan S Drake "The Fall and Rise of the Exit Consent" (2014) 63 Duke LJ 1589; Jerry Koh and Evangeline Oh "Re-Examining Bondholders' Rights in Exchange Offers" (2015) 16 Bus L Int'l 119. For a detailed discussion of exit consents and consent payments see chapter 7 "Exit Consents in Debt Restructurings".

11 Philip Rawlings "International Bonds and Trustees" (2005) 19 Tru L I 205; "The Changing Role of the Trustee in International Bond Issues" [2007] JBL 43; "Reinforcing Collectivity: the Liability of Trustees and the Power of Investors in Finance Transactions" (2009) 23 Tru L I 14.

12 Even in the event of a bond default, bond trustees are not likely to be sued by the bondholders because, traditionally, bondholders prefer not to reveal their identity in litigations and will rather leave to the trustee to negotiate with the issuer to resolve the default. Neil Esho, Michael G Kollo and Ian G Sharpe "Eurobond Underwriter Spreads" (2006) 46 Accounting and Finance 71 at 75.

by their very nature, are more prone to default risks.[13] The second change is the rise of a new type of bond investors, represented by American hedge or vulture funds. Their investment strategy is to maximise the value of their investment by pressing their legal rights to the fullest. In this environment, the trustee's exercise of discretion will be subject to scrutiny by bondholders. Structural changes may be required to ensure that trustees are able to resist pressure from bondholders.

In 1913, the fourth edition of the book entitled *A Treatise on the Law Relating to Debentures and Debenture Stock*, written by Paul Frederick Simonson, was published.[14] This book dealt exhaustively with the nature of the various classes of debentures and debenture stock, stamp duties, the registration of the charges, and the transfer of such securities. It also covered the rights and remedies of a debenture holder against the issuer and the trustee. It seems that this book remains until today the only book fully dedicated to the law of bonds and bond trusts. Since then, the topic of bond trusts is usually covered in financial law textbooks,[15] such as *The Law and Regulation of International Finance* written by Ravi C Tennekoon,[16] *Corporate Borrowing: Law and Practice* written by Geoffrey Fuller,[17] and *Corporate Finance Law: Principles and Policy* written by Louise Gullifer and Jennifer Payne.[18]

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13 Junk bonds are bonds issued by issuers with low credit worthiness.

14 Paul Fredrick Simonson *A Treaties on the Law Relating to Debentures and Debenture Stock* (4th ed, Effingham Wilson and Sweet & Maxwell, London, 1913).

15 English law textbooks on equity do not usually discuss bond trusts. See for example Jill E Martin *Modern Equity* (16th ed, Sweet & Maxwell, London, 2001); Philip H Pettit *Equity and The Law of Trusts* (10th ed, Oxford, London, 2006).

16 Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991).

17 Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009).

18 Louise Gullifer and Jennifer Payne *Corporate Finance Law: Principles and Policy* (Hart Publishing, London, 2011).

1.2.2 Literature on bond trusts governed by US law

Starting in the late 1800s the total volume of bonds issued under a trust indenture[19] increased rapidly, resulting in a flurry of cases fuelled by corporate defaults during the Great Depression and an expansion of legal literature in this field.[20] One notable scholar in this field is Louis Posner. In a 1928 article, he offered an in-depth analysis of the liability of the indenture trustee.[21] Posner pointed out that the indenture trustee should not be treated as an ordinary trustee because doing so would overstate the extent of its duties and subject it to a standard of conduct not required by the nature of the trust. Indeed, the liability of the indenture trustee was to a large extent a matter of contract, as opposed to a matter of the trust relationship. Imposing implied duties upon indenture trustees could hinder the usefulness of the trust indenture device in finance. On the other hand, however, the public confidence placed on financial institutions engaged in the business of trusteeship of corporate bonds called for the imposition of at least the standard of ordinary care which the facts of a situation demanded. In a later article, Poster further expanded on this idea and suggested that legislation be put in place to clarify standards of trustee behaviour.[22]

During the three decades following the enactment of the Trust Indenture Act of 1939 (US) (the TIA),[23] there had been relatively little judicial activity in respect of trust indentures due to a lack of corporate defaults. In 1970, William Johnson wrote a three-instalment article covering five aspects of the indenture trustee's obligations: the general nature of the indenture trustee's

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19 "Trust indenture" is the American equivalent of an English trust deed. The term "indenture trustee", as used in this thesis, means the trustee of the bonds governed by US law.

20 In 1934, the total amount of bonds issued under trust indentures has reached US$37 billion. Louis S Posner "The Trustee and the Trust Indenture: a Further Study" (1937) 46 Yale L J 737.

21 Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) 42 Harv L Rev 198.

22 Louis S Posner "The Trustee and the Trust Indenture: a Further Study" (1937) 46 Yale L J 737 at 789–790.

23 15 USC §§ 77aaa–77bbbb.

responsibility, events of default, default remedial provisions, alternatives to default remedial provisions and judicial arrangements and reorganisations.[24]

He observed that, while there remained a substantial amount of speculation regarding the prudent man standard of care imposed on the trustee, this standard became applicable only after an event of default had occurred.[25] After default, the trustee had an impressive arsenal of remedies at its disposal and, subject to certain exceptions and limitations, had broad discretion as to their use. Nevertheless, the trustee should carefully consider any feasible alternative method of curing the issuer's default. If bankruptcy proceedings had occurred, other than the duty to file proofs of claim for the bondholders, the trustee had little positive duty or authority to act for the bondholders in regard to their claims. In particular, if a trustee involved itself in the merits of a reorganization plan, it could be exposed to substantial liability, because the propriety of a reorganisation plan was to be judged by the court or the appropriate administrative agency, not the trustee.

In 1969, the American Law Institute initiated the Federal Securities Code aiming to revise and integrate six federal laws relating to securities.[26] This project, and a number of major bankruptcies occurring in the 1970s, prompted commentators to rethink some of the provisions of the TIA. Howard Friedman proposed that to address the issue of inside information, the corporate trust activities of an indenture trustee should be segregated from its other trust

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24 William A Johnson "Default Administration of Corporate Trust Indentures: the General Nature of the Trustee's Responsibility and Events of Default" (1970) 15 St L ULJ 203; "Default Administration of Corporate Trust Indentures: Default Remedial Provisions" (1971) 15 St L ULJ 374; "Default Administration of Corporate Trust Debentures: Alternatives to Default Remedial Provisions and Judicial Arrangements and Reorganizations" (1971) 15 St L ULJ 509.

25 Section 315(c) of the Trust Indenture Act of 1939 (US) (the literature of the TIA generally uses the section numbers of the TIA and that convention will be followed here. Parallel citations to the United States Code will not be provided); section 601(b) of the two sets of the model corporate trust indenture provisions published by the American Bar Foundation in 1965 and in 1967 respectively.

26 The project was completed in 1980.

activities which might involve trading by the trustee of the issuer's securities, or the trustee should be required to disclose large scale of sales of such securities. His other proposals included a mandatory requirement on the trustee to exercise the same prudent man standard of care and skill in discovering the existence of a default and, in cases where the trustee is also a lender to the issuer, an enhanced mandatory sharing regime in respect of the proceeds recovered by the trustee-lender under the loan.[27] In a 1977 article, John P Campbell and Robert Zack took the point about trustee-lender further and suggested a complete ban on the indenture trustee from making loans to the issuer.[28]

Two notable contemporary scholars on bond trusts are Marcel Kahan and Steven L Schwarcz. In 1999, Kahn, together with Yakov Amihud and Kenneth Garbade, proposed an optional new governance structure for publically issued corporate bonds. The key idea under the proposed structure is the concept of "super-trustee" who will have the power and the duty to monitor, renegotiate, and enforce bond covenants.[29] In 2002, Kahan identified the flaws in the structure of individual and collective rights of bondholders, and suggested that courts should modify the way in which the no-action clause is interpreted; and that the contractual provisions regarding bondholder enforcement in the indenture should be revised.[30] In 2009, Kahan co-authored with Edward Rock an article entitled "Hedge Fund Activism in the Enforcement of

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27 Howard M Friedman "Updating the Trust Indenture Act" (1974) 7 Journal of Law Reform 329. Compare Frederica R Obrzut "The Trust Indenture Act of 1939: The Corporate Trustee as Creditor" (1976) 24 UCLA LR 131.

28 In 1990, the TIA was amended to prohibit the trustee from being or becoming a creditor of the issuer after a default has occurred. Section 310(b)(i) of the TIA.

29 Yakov Amihud, Kenneth Garbade and Marcel Kahan "A New Governance Structure for Corporate Bonds" (1999) 51 Stan L Rev 447. For criticism of the super-trustee proposal, see Efrat Lev, Adv "The Indenture Trustee: Does It Really Protect Bondholders" (1999) 8 U Miami Bus L Rev 47 at 115.

30 Marcel Kahan "Rethinking Corporate Bonds: The Trade-off Between Individual and Collective Rights" (2002) 77 NYULR 1040.

Bondholder Rights".[31] Their research shows that, while traditionally bond investors have taken a hand-off approach regarding violations of bond covenants, hedge funds investigate potential defaults, buy bonds when a right opportunity arises, and vigorously enforce their rights when acceleration is attractive due to the changes in treasury interest rates and, for convertible bonds, changes in the price of the shares into which the bonds can be converted into. They proposed a set of modifications that could fix this over-enforcement problem.

In a 2008 article, Steven L Schwarcz and Gregory M Sergi highlighted the dilemma of the indenture trustee in a bond default.[32] If the trustee decides to enforce, it might result in less recovery for bondholders than an out-of-court restructuring; if it does not act, the trustee would face potential liability for negligence. To solve this problem, Schwarcz and Sergi argued that the business judgment rule should apply to indenture trustees. The protection afforded under the business judgment rule would induce indenture trustees to take such risks calculated to maximize the value paid to bondholders post default.

In 2010, Schwarcz discussed another type of dilemma faced by the indenture trustee where the bondholders have conflicting interests.[33] He concludes that the indenture trustee should not be obligated to follow bondholders' directions that are not reasonably related to the intended contractual benefits or could trigger market failures. Most recently, Schwarcz argued that, based on the facts that bond issuances are now the dominant source of corporate financing

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31 Marcel Kahan and Edward Rock "Hedge Fund Activism in the Enforcement of Bondholder Rights" (2009) 103 NWULR 281. This chapter builds upon their earlier discussion of shareholder activism of hedge funds. Marcel Kahan and Edward Rock "Hedge Funds in Corporate Governance and Corporate Control" (2007) 155 U PA L Rev 1021.

32 Steven L Schwarcz and Gregory M Sergi "Bond Defaults and the Dilemma of the Indenture Trustee" (2008) 59 Ala LR 1037.

33 Steven L Schwarcz "Fiduciaries with Conflicting Obligations" (2010) 94 Minn LR 1867.

and the bondholders' vested interest in the issuer's performance, bondholders should be included in the governance of systemically important companies.[34]

The long-running textbook entitled *Corporate Trust Administration and Management*, currently in its seventh edition, has been widely regarded as the definitive work on corporate trust administration.[35] It covers both the responsibilities of the indenture trustee and the day-to-day operations.

1.3 Need for academic research on bond trusts

A number of recent market trends have made a contemporary study of the laws of bond trusts imperative. First, the increasing number of bond defaults have placed the post-default role of bond trustees on the central stage. It can no longer be said that "defaults are a very minor part of the corporate trust indenture business."[36] Instead, bond trustees play a crucial function in the post-default enforcement of bondholders' legal rights. This has given rise to various legal issues. For instance, when the senior bondholders instruct the trustee to take certain actions, is the trustee obliged to consider the interests of the junior bondholders? What level of indemnity is the trustee entitled to demand from the bondholders? Is the trustee entitled to select its own counsel as the leading counsel to initiate litigation proceedings without consulting the bondholders, despite the legal fees being borne by the bondholders?[37]

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34 Steven L Schwarcz "Rethinking Corporate Governance for a Bondholder Financed, Systemically Risky World" (2017) 58 Wm & Mary LR 1345.

35 Robert I Landau and Remano I Peluso *Corporate Trust: Administration and Management* (7th ed, Infinity, Philadelphia, 2015).

36 Richard B Smith, Stephen H Case and Francis J Morison "The Trust Indenture Act of 1939 Needs No Conflict of Interest Revision" (1979) 35 The Business Lawyer 161 at 165.

37 Esther Cavett "When the Music Starts Again: How Should Trustees Conduct Themselves in the New World?" (2010) 25 JIBFL 469; Saptak Santra "Bondholders, Fight Back" (2010) 29 IFLR 26. For a debate on the role of trustee in the context of securitisation, see Claire M Robinson "Moody's Re-examines Trustees' Roles in ABS and RMBS" (Moody's Investors Service, 4 February 2003); Association of

The second market trend is the rise of bondholder activism. Historically, many technical defaults[38] are either undetected or unsanctioned. Today, hedge funds and other private investment managers closely investigate whether technical defaults have or may have occurred, and enforce their contractual rights to maximise the returns.[39] Similarly, when the issuer proposes a restructuring plan, an activist bondholder may refuse to participate.[40] The issues and challenges brought by bondholder activism make the inquiry into the role of bond trustee, and the bond trust law in general, additionally timely.

Thirdly, debt markets are expanding rapidly in emerging markets.[41] The proper functioning of local debt markets requires a well-functioning legal system, and creditor-friendly bond laws and bond structures will foster the development of local bond markets. Legislators and regulators in the emerging markets may need to draw lessons from the legal systems of more developed bond markets, such as English law and US law.

It is also worthwhile to note that, given the increasingly important role played by bond investors in corporate financing, public bondholder governance is being gradually recognised

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Mortgage Investors "Reforming the Asset-Backed Securities Market" (White Paper, March 2010); American Bankers Association, Corporate Trust Committee "The Trustee's Role in Asset-Backed Securities" (9 November 2010) <www.aba.com>.

38 Technical defaults refer to defaults other than failures to pay or insolvency.

39 One example is the failure of BearingPoint, Inc to file its annual report with the Securities Exchange Commission (US) in 2006. Three hedge fund bondholders served a notice of default and instructed the indenture trustee to bring suit against BearingPoint. The case was withdrawn after the issuer agreed to increase the interest rates. BearingPoint, Inc *Form 10-K Annual Report* at 21–22 <www.sec.gov>.

40 One prominent example of bondholder activists is Elliott Management Corporation. One of its key investment strategies is distressed debts.

41 Luc Laeven "The Development of Local Capital Markets: Rationale and Challenges" (IMF Working Paper, WP/14/234, December 2014) at 6.

as a critical component of corporate governance.[42] A study of the laws of bond trusts is a necessary component for future research on public bondholder governance.

1.4 Thesis structure

Following this introduction, this thesis develops through six substantive chapters.[43] Chapter 2 gives a general description of bond markets and the bond trust structure. It traces the historical origin of bond markets, introduces the types of bonds and discusses the legal forms of bonds. Chapter 2 also summarises the legal and commercial reasons for using a trust structure in bond issues and introduces the key terms of a bond trust deed.

Chapter 3 discusses and compares the laws of bond trust in four common law jurisdictions, the UK, the US, Australia and New Zealand. It points out that, while there are certain differences between the English bond trust law and the US bond trust law, the two legal regimes share significant similarities. In particular, English or US bond trustees only have a limited duty to monitor the performance of the issuer. In contrast, both Australian and New Zealand laws require bond trustees to exercise reasonable diligence to ascertain whether any breach of the bond trust deed has occurred and whether the issuer's assets are sufficient to discharge its obligations under the bonds. Chapter 3 also contains a brief introduction of the bond trust law in four civil law countries, namely Germany, Japan, South Korea and China.

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42 Steven L Schwarcz and Gregory M Sergi "Bond Defaults and the Dilemma of the Indenture Trustee" (2008) 59 Ala LR 1037 at 1040; Serdar Çelik, Gül Demirtaş and Mats Isaksson "Corporate Bonds, Bondholders and Corporate Governance" (OECD Corporate Governance Working Papers No 16, 2015) at 48–59.

43 Each of chapters 2 to 7 is written in the form of a standalone paper.

Chapter 4 offers an in-depth analysis of the bond trust regime under New Zealand law.[44] As a result of the recent securities law reform and case law developments, the monitoring duties of New Zealand bond trustees have been strengthened and expanded. This chapter discusses various issues under the new regime. Specifically, it argues that the monitoring duties are too onerous and are therefore unlikely to achieve their purposes. It is proposed that the New Zealand financial markets regulator is better positioned to take on this role.

Chapter 5 looks at the nature of the bond trust and the security trust from an English law perspective.[45] It argues that bond trusts and security trusts are fundamentally different from other types of express trust. This is due to the secondary nature of the trust estate of such trusts. Unlike a typical express trust (for example, a family trust), the trust property of a bond trust or security trust does not have an independent economic value. As a result, the beneficiaries of a bond trust or security trust do not enjoy the same protection against the settlor or the trustee as in other express trusts. It is proposed that bond trusts and security trusts should be regarded as multilateral contracts, and that the trustee be regarded as an agent. The trustee's duties and liabilities should be analysed under a contractual framework in accordance with the presumed intention of the parties.

Chapter 6 looks at the US and UK case law regarding the no-action clause.[46] The no-action clause, which provides that bondholders may not proceed against an issuer unless certain conditions are met, is included in almost all bond trust instruments. Chapter 6 compares two approaches in interpreting this clause, the expansive approach and the restrictive approach, and

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44 This chapter first appeared as "From 'Bond Trustee' to 'Supervisor': A Critical Review of the Bond Trust Regime under the Financial Markets Conduct Act 2013" 22 NZBLQ 100, and is reproduced here with permission of Thomson Reuters.

45 This chapter has been accepted for publication and will first appear in Journal of Business Law (2017).

46 This chapter first appeared as "No-action Clause in Bond Trust" (2014) 25 JBFLP 1, and is reproduced here with permission of Thomson Reuters.

argues that the former should be preferred. Chapter 6 also analyses whether pre-default claims are covered by the no-action clause, and in what situations the claim of a bondholder is an individual claim (which is not barred by the no-action clause) as opposed to a class claim (which is barred). The no-action clause has been subjected to strong criticism in recent years. Possible solutions could include imposing a duty of information disclosure on the trustee and active participation by the bondholders in the enforcement process.

Chapter 7 discusses exit consents. The exit consent technique refers to an offer by a bond issuer to all the bondholders to exchange the existing bonds for new bonds or other types of securities, on the condition that the tendering bondholders must consent to a resolution which will amend the terms of the existing bonds so as to make the bonds less attractive. It argues that exit consents do not violate s 316(b) of the TIA (US) because s 316(b) only prohibits non-consensual amendments to an indenture's core payment terms.

It further argues that the application of the English law abuse principle in exit consent cases should be considered in the light of the factual context and the parties' presumed intentions. A bondholder's decision to give exit consent does not violate the abuse principle because it is simply making a rational choice. In addition, it cannot possibly be the parties' presumed intention that, when the issuer has made an exchange offer coupled with an exit consent, the bondholders are required to prioritise the interests of the dissenting bondholders over their own interest.

Chapter 8 offers a few concluding observations. After reiterating the two central claims of this thesis – the ineffectiveness of monitoring duties and the contractual nature of bond trusts, it points out the need for courts to take a cautious approach to imposing duties which are inconsistent with the express terms of the contract, or interpreting contractual terms in ways fundamentally different from the general view of market participants. Certain areas of future research are also highlighted, including the role of a trustee in peer-to-peer lending, and the bond trust law in China.

CHAPTER 2 BONDS AND BOND TRUSTS

2.1 Bond markets

> I used to think that if there was reincarnation, I wanted to come back as the President or the Pope… But now I would like to come back as the bond market. You can intimidate everybody.[1]

In the mid-nineteenth century, secured debentures related to railways were issued in the London market.[2] Around the same period, secured bond markets started to emerge in the US due to the fast expanding funding needs of infrastructure construction such as roads, bridges, and canals. After the First World War, due to restrictions imposed by the British government, the London capital market shrank. As a result, New York became the leading international financial center.[3] After the Second World War, the amount of US dollars held outside the US increased significantly,[4] and London became the center of the eurodollar market.[5] The pool of eurodollars made the issue of US$ denominated bonds outside the US possible. In 1963, Autostrade, an Italian company, issued US$ bonds in London. This event is generally accepted as the beginning of the modern international bond market.[6]

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1 James Carville, political advisor to President Clinton (reported in Bloomberg, 10 February 2009) as cited in Colin Bamford *Principles of International Financial Law* (2nd ed, Oxford University Press, Oxford, 2015) at [6.01].

2 Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [2.33].

3 At [2.42–2.43].

4 This is mainly caused by two reasons: the large amounts of US dollars received by European companies which were involved in the rebuilding of Europe financed by the US government under the Marshall Plan, and the preference of the USSR and its allies to hold assets outside the US. Colin Bamford *Principles of International Financial Law* (2th ed, Oxford University Press, Oxford, 2015) at [6.27–6.33].

5 The term "eurodollar" refers to US dollars held outside the US.

6 Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 9.

Generally speaking, international bonds are bonds issued by offshore issuers and denominated in the domestic currency (the foreign bonds)[7] or a foreign currency (the eurobonds).[8] International bonds are governed by English law, New York law or the law of the jurisdiction in which the issuer is incorporated. Domestic bonds are bonds issued by local issuers, denominated in the local currency and governed by the local law.

Worldwide, primary bond markets are a vital source of funds for financial and non-financial corporations, and are expected to be a much more important tool for the global economy going forward.[9] For example, corporate bond markets have reached US$49 trillion in 2013, tripling in size since 2000.[10] As of 2016, the total size of US corporate bonds alone is over US$8 trillion.[11]

The rapid expansion of bond markets in recent years has given rise to the emergence and development of the credit default swap markets. Traditionally, the main risk faced by a bond investor is the credit risk of the issuer; that is, in the case of a default, the investor may not get its full investment back. Using credit default swaps, bondholders are now able to purchase protection against the credit risk of the issuer from a third party who is willing to take the credit

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7 Eg an Australian issuer issuing NZ dollar denominated bonds in the New Zealand market.

8 Eg an Italian issuer issuing US$ denominated bonds in the London market. For an account of the history and development of the eurobond market, see Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [2.46–2.98]. The term "eurobond" should not be confused with "Eurobonds" which, under a 2010 proposal, are bonds to be jointly issued by the members of the eurozone. See further Sylvester C W Eijffinger "Eurobonds – Concepts and Implications" (European Parliament, Directorate General for Internal Policies, Policy Department A: Economic and Scientific Policies, Economic and Monetary Affairs, March 2011).

9 International Capital Market Association "Economic Importance of the Corporate Bond Markets" (March 2013) <www.icmagroup.org> at 5.

10 Rohini Tendulkar and Gigi Hancock "Corporate Bond Markets: A Global Perspective" (OICV–IOSCO SWP4/2014, February 2014) <www.iosco.org> at 3.

11 Securities Industry and Financial Markets Association "US Bond Market Issuance and Outstanding" (09 March 2017) <www.sifma.org>.

risk of the issuer for a fee. This may have a huge impact on the post-default behaviour of bondholders. While usual bondholders might be actively involved in the enforcement process (such as giving the bond trustee enforcement instructions and attending bondholders' meetings), a bondholder which has purchased credit protection will have no incentives to participate as it will receive the full investment back no matter how much the actual recovery rate is.

2.2 Types of bonds

Bonds can be categorised in various ways. By the maturity date, bonds can be divided into medium-term notes,[12] and long-term bonds. According to the types of issuers, bonds can be divided into government bonds, financial corporate bonds, and non-financial corporate bonds. In terms of ranking, bonds can be divided into subordinated bonds, senior unsecured bonds, secured bonds and covered bonds.[13] According to the structure, bonds can be divided into plain vanilla notes, structured notes, and asset-backed notes.

The return of plain vanilla notes is relatively straight-forward: it is based on either a fixed rate or a floating rate. By contrast, the payoff of structured notes is linked to certain other factors, such as foreign exchange rates, stock prices or commodity prices. Most structured notes are issued by banks or special purpose vehicles (SPV). Normally structured notes issued by banks are unsecured. Structured notes issued by SPVs are secured over certain underlying assets held by the issuer. The return of the structured notes issued by SPVs can be the same as the return of the underlying assets (such notes being called pass-through notes), a fixed or floating rate, or linked to certain other assets. In the latter two cases, the issuer will need to enter into a

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12 Medium term notes are notes with a maturity of one to five years.

13 Covered bonds are generally issued by banks and secured over a specific pool of assets which are segregated from the issuer's balance sheet.

swap transaction with a swap counterparty under which the issuer pays to the swap counterparty the return on the underlying assets, and receives the payments specified under the terms of the notes.[14]

Asset-backed notes are also called securitisation. Under a securitisation structure, an SPV issues bonds to investors and uses the issue proceeds to purchase certain financial assets (such as mortgages loans, credit card receivables and student loans) from a seller (called the originator). While there are certain similarities between securitisations and pass-through notes, the key difference is that the underlying assets under the pass-through notes are homogeneous (such as the bonds issued by one issuer), whereas the underlying assets under a securitisation structure are a lot more complex, sometimes consisting of hundreds or thousands of loans owed by different debtors.

2.3 Form of bonds

Bonds can be issued in registered form, under which the bondholders' names are entered in a register kept by or on behalf of the issuer, or in bearer form in which case the bondholder is the person whoever holds the bond printed on a piece of paper. Bearer bonds are negotiable and anonymous - the title to and property in a bearer bond and all rights under it pass to a bona fide holder for value by physical delivery.

During the late nineteenth century, the registered form was the dominant choice for bonds issued by the UK companies because of the then stamp duty requirements.[15] When the

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[14] The duties of trustees of structured notes are more complicated than those under corporate bonds. Under the trust deed of structured notes, the beneficiaries include not only the bondholders but also the swap counterparty. The swap counterparty's claim ranks above the claim of the bondholders. Issues may arise where there is a conflict between the bondholders and the swap counterparty.

[15] Colin Bamford *Principles of International Financial Law* (2nd ed, Oxford University Press, Oxford, 2015) at [6.36]. Today, in certain counties (such as New Zealand), the local practice is that bonds are issued in a registered form.

eurobond market started to develop in the 1960s, the market favoured the bearer form due to its negotiability and anonymity. However, the bearer form exposes the bondholders to numerous risks such as theft and fire. In addition, when a bearer bond is sold, the seller will have to physically deliver the bond to the buyer. To address these concerns, international bonds are now issued through a clearing system[16] under a global bond structure. As a result, the distinction between the bearer form and the registered form has, in practice, become largely irrelevant.[17]

Under the global bond structure, in terms of bearer bonds, a global bearer bond is issued to and held by a depositary (usually a major commercial bank) on behalf of the clearing system. If the bonds are in the registered form, a nominee company of the clearing system is entered in the register as the holder of the global bond, and a global certificate is held by a depositary on behalf of the clearing system.[18] The clearing system acts as a bare trustee. Accountholders in the clearing system hold a share in the beneficial interest in the global bond corresponding to the amount of bonds it holds.[19]

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16 For international bonds, the clearing systems are Euroclear and Clearstream. Each local bond market usually has their own clearing systems, such as Depository Trust Company for the US bond market, Austraclear for the Australian bond market and China Securities Depository & Clearing Corporation Limited for the PRC bond market.

17 Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [1.106].

18 In terms of bonds issued through both Euroclear and Clearstream, Euroclear and Clearstream will jointly appoint a 'common depository" to hold the global bond or the global certificate on their behalf.

19 For a general discussion of the legal issues of the global bond structure, see Ravi C Tennekoon *The Law & Regulation of International Finance* (Butterworths, 1991) at 171–174; Colin Bamford *Principles of International Financial Law* (2nd ed, Oxford University Press, Oxford, 2015) at [6.72–6.130]. For a discussion of the global bond structure in the context of s 425 of the Companies Act 1985 (UK) (the predecessor of s 899 of the Companies Act 2006 (UK)), see Charles Maunder "Bondholder Schedules of Arrangement: Playing the Numbers Game" (2003) 16(10) Insolv Int 73.

In 2010, a new custody structure was put in place for euro-denominated bonds. Under the new structure, the global bond is held by a clearing system directly, rather than by a commercial bank as the depositary. This removes the perceived legal risk that, in case the depositary becomes insolvent, its liquidator might claim an entitlement to the deposited global bond.[20] The new structure is mandatory to enable euro-denominated bonds to be recognised as eligible collateral for the Eurosystem monetary policy and intra-day credit operations.[21]

2.4 Documentation

2.4.1 English law governed bond trusts

In terms of a typical corporate eurobond issue under a trust deed governed by English law, the documentation process starts with the negotiations between the potential issuer and one or more financial institutions acting as the lead manager. The lead manager will instruct lawyers to prepare drafts of the legal documents, such as the offering circular,[22] the trust deed or the supplemental trust deed (if the bonds are issued under a medium term note programme), the subscription agreement, and other ancillary documents.[23] The trustee, assisted by its legal counsel, will review the draft documents, although in most cases their comments are focused on the terms of the trust deed. At the closing, the final documents are executed, the bonds are issued and the issuer will receive the issue proceeds. In most cases, bond investors are not involved in the negotiation of the documentation.

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20 Colin Bamford *Principles of International Financial Law* (2nd ed, Oxford University Press, Oxford, 2015) at [6.116].

21 For further information see ICMCA and others *New Global Note Structure* (General Information Brochure, 1 July 2006) < www.clearstream.com>.

22 This document may also be called a "prospectus" or "information memorandum". For simplicity, the term "offering circular" will be used in this thesis.

23 Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd ed, Sweet & Maxwell, London, 2007) at [10.028–10.034].

The offering circular is meant to be the main marketing document. It contains the terms and conditions of the bonds (or a summary thereof), a summary of the trust deed terms, a description of the issuer, and its financial information. Where applicable, the contents of the offering circular need to comply with the relevant statutory requirements or listing rules.

The trust deed deals with matters such as appointment, retirement, and removal of the trustee, the trustee's powers and duties, and remuneration and indemnification.[24] The form of the conditions of the bonds is included in a schedule to the trust deed. These conditions cover matters such as the form and denomination of the bonds, the status of the bonds, interest on the bonds, redemption, covenants[25] and events of defaults.

Events of default usually include the following:

- the issuer fails to pay the principal on the due date, or fails to pay the interest on the due date and such failure continues for a specified number of days (failure to pay);
- the issuer fails to perform or observe any of its other obligations under the terms of the bonds or the trust deed, and such failure continues for a specified number of days following the notification by the trustee on the issuer requiring the failure to be remedied (obligation default);
- the issuer defaults under any other debt obligation (cross-default) or any of the issuer's debt becomes due and repayable prematurely by reason of an event of default (cross-acceleration);

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24 Generally speaking, the fee arrangement between the issuer and the trustee will not be set out in the trust deed. Rather it is contained in a separate fee letter. The level of trustee fees is not disclosed to bondholders.

25 As a general rule, bond covenants are less extensive than in term loans. William W Bratton "Bond Covenants and Creditor Protection: Economics and Law, Theory and Practice, Substance and Process" (2006) 9 EBOR 39.

- liquidation or similar proceedings are initiated against the issuer, and such proceedings are not discharged within a specified number of days (bankruptcy).

Upon the occurrence of an event of default, the trustee at its discretion may give notice to the issuer to accelerate the bonds. In addition, if the trustee is requested by the holders of at least 20 per cent in principal amount outstanding of the bonds or directed by an extraordinary resolution of the bondholders, the trustee shall accelerate the bonds. In each case, the trustee may demand the bondholders to provide satisfactory indemnity before taking any action. No bondholder is entitled to take any action against the issuer unless the bond trustee, having become bound to proceed, fails to take action against the issuer within a reasonable period of time (the no-action clause).

2.4.2 Trust indentures governed by US law

In general terms, the role of the trustee under a US indenture is more explicitly set out, whereas the provisions regarding the trustee in an English law trust deed are wider and less stringent. In terms of publicly issued bonds, the TIA (US) deems certain mandatory provisions to be contained in the trust indenture. As to trust indentures not subject to the TIA (US), the TIA-deemed provisions are usually replicated in the trust indenture.[26]

There are two key differences between an English trust deed and a US trust indenture. The first one is the entrenchment of each bondholders' payment rights under s 316(b) of the TIA (US). As a result, each bondholder is entitled to sue for any unpaid amounts, the payment terms of the bonds cannot be amended without unanimous consent, and the trustee cannot waive

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26 A 2004 research shows that certain sovereign bonds contain the English-style collective action clauses under which the majority of the bondholders are entitled to agree to amendments to the bond payment terms, although these bonds are governed by New York law. Mark Gugiatti and Anthony Richards "The Use of Collective Action Clauses in New York Law Bonds of Sovereign Borrowers" (11 July 2003) Social Science Research Network <www.ssrn.com>.

a payment default without the consent of the relevant bondholders.[27] The second difference is that, after the occurrence of an event of default, the US indenture trustee must exercise the same degree of care and skill as a prudent man would exercise under the circumstances in the conduct of one's own affairs. This is in contrast to the professional trustee standard of care under English law.

2.5 Reasons for a trust structure

From the early 19th century, secured bonds became a popular way of raising finance for issuers. However, since the bonds were usually held by numerous scattered and changing bodies of investors, it was impracticable to transfer the security directly to the bondholders. To reduce the hassle, the issuer chose to transfer the security to a third person who held it on trust for the benefit of the bondholders. The trust structure gradually gained popularity and a trustee is now appointed for most non-financial corporate bond issues whether or not they are secured.

There are many advantages to appointing a trustee.[28] From the bondholders' perspective, given that the trustee has rights to obtain information from the issuer, it is likely to be able to provide more sophisticated monitoring of the issuer's compliance with covenants.[29] Compared to individual investors, a professional corporate trustee also has better resources and easy access

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27 Geoffrey *Fuller Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at [3.69–3.70]. For further discussion of s 316(b), see chapter 7 "Exit Consents in Debt Restructurings".

28 For discussions on the advantages and disadvantages of having a trustee for bond issues, see Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd, Sweet & Maxwell, London, 2007) at [16.001–16.005]; Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 16–17.

29 It has been suggested that trustees can play a role in mitigating fraud in structured financings. Margery A Colloff "The Role of the Trustee in Mitigating Fraud in Structured Financings" (2005) 10(4) Journal of Structured Finance 73.

to accountants and lawyers. Where a breach has occurred, the trustee will take one unified action on behalf of all the bondholders. It also has the right to waive some breaches, if it believes this is in the best interests of the bondholders. Furthermore, all moneys recovered by the trustee are distributed to the bondholders pro rata, which would not be the case if each bondholder were to take individual action against the issuer.[30]

Having a trustee is also advantageous for the issuer. First and foremost, it provides the issuer with protection against "mad bondholders", because only the trustee is entitled to trigger an event of default and take enforcement action. That is particularly important where the breach is relatively minor. The trustee may choose not to take any action against the issuer. If there were no trustee, certain investors may try to take advantage of such a technical breach by strictly enforcing its contractual rights, hoping to receive a windfall. Secondly, it is easier for the issuer to modify the bond terms where a manifest error has been identified.

The third advantage for the issuer is that having a trustee can be perceived by bond investors as important and necessary. Accordingly, the issuer might be able to offer bonds at a lower price than it would be able to if no trustee had been appointed. It was observed in *Merrill v Farmer's Loan & Trust Co* that the saleability of corporate bonds "depends in no considerable degree upon the character of the persons who are selected to manage the trust. If they are of well-known integrity and pecuniary ability, the bonds are more readily sold than if this were not the case."[31] While these words were uttered more than 100 years ago, they still ring true in cases where the issuer is a relatively unknown name, but the trustee is an affiliate or department of an international bank.

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30 The importance of bond trustee is also shown in insolvency cases where, the relevant bankrupt issuer not having appointed a trustee, the court appointed a trustee to act as the representative of all bondholders. See Kyong Lee and Karkus Heidinger "Bondholders in Insolvency Proceedings against an Austrian Issuer – the Maculan Case" (1998) 13 JIBL 118.

31 *Merrill v Farmer's Loan & Trust Co* 24 Hun 297 (NY 1881) at 299.

While the role of bond trustee is generally unnoticed during normal times, it is brought into the spotlight during financial crises. Doubts have been raised as to whether the bond trustee really fulfils the purpose for which it is appointed – that is, protecting the interests of the bondholders.[32] This issue will be returned to later.

2.6 Bonds without a trustee

While the use of bond trusts is widespread in corporate bond issues, it is not universal.[33] Instead of appointing a bond trustee, the issuer may choose to appoint a fiscal agent.[34] The fiscal agent will act as paying agent of the issuer, and may also have certain administrative functions such as to publish notices.[35] The fiscal agent is an agent of the issuer, which means that it owes no duty to, and hence will not act for, the bondholders. Upon the occurrence of an event of default, each bondholder is entitled to take enforcement action against the issuer (although this may be subject to approval by the bondholders holding a certain percentage of the bonds).[36]

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32 See for example Efrat Lev, Adv “The Indenture Trustee: Does It Really Protect Bondholders” (1999) 8 U Miami Bus L Rev 47; Saptak Santra “Bondholders, Fight Back” (2010) 29 IFL Rev 26; Esther Cavett "When the Music Starts Again: How Should Trustees Conduct Themselves in the New World?" (2010) 25 JIBFL 469.

33 In certain civil law countries, such as Luxembourg, Switzerland, the Netherlands, and Germany, fiduciary representatives are appointed for bondholders. Philip Wood *Law and Practice of International Finance* (Sweet & Maxwell, London, 2008) at [12.28].

34 Where the bonds are issued under a trust structure, the issuer will appoint a paying agent which performs a role similar to a fiscal agent. As to the US law governed bonds, the indenture trustee usually performs certain functions similar to those of a fiscal agent.

35 Albert S Pergam “Choosing Between the Trustee and Fiscal Agent for Eurobonds” (1985) 4 IFLR 8.

36 Sönke Häseler “Trustees Versus Fiscal Agents and Default Risk in International Sovereign Bonds” (2012) 34 Eur J Law Eco 425 at 429.

It is worthwhile to note that, for sovereign bond issues, very often trustees are not appointed, "since states consider it below their dignity to be monitored by a trustee."[37] In addition, investors may fear that giving enforcement right to the trustee would take away the necessary deterrent against opportunistic sovereign defaults.[38] However, the lack of a collective action mechanism means that, in case the issuer country is in financial difficulty and proposes to restructure the bonds, any bondholder may refuse to participate, thus thwarting the whole process. In recent years, both the International Monetary Fund and the European Union have taken measures to promote the adoption of collective action clauses in sovereign bonds.[39]

2.7 Use of trust in finance in general

While the trust structure remains very relevant in modern estate planning practice,[40] its most far-reaching use in modern times is in the commercial context and, in particular, in financial markets.[41] In fact, the device of the trust structure has become an integral part of the mechanism of modern finance. Trust structures are used not only for corporate bond issues, but also in many other types of financial transactions. Three are summarised below.

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[37] Philip Wood *Law and Practice of International Finance* (Sweet & Maxwell, London, 2008) at [12.27]. Occasionally, a trustee is appointed for sovereign bonds. See Michael Bradley and Mitu Gulati "Collective Action Clauses for the Eurozone" (2014) 18 Review of Finance 2045 at 2074.

[38] See Jill E Fisch and Caroline M Gentile "Vultures or Vanguards? The Role of Litigation in Sovereign Debt Restructuring" (2004) 53 Emory LJ 1047.

[39] See Robert Auray "In Bonds We Trustee — A New Contractual Mechanism to Improve Sovereign Bond Restructurings" (2013) 82 Fordham L Rev 899.

[40] For example, the use of family trusts in New Zealand is widespread.

[41] Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 1.

2.7.1 Collective investment schemes

Investors may want to pool their funds together for a number of reasons, such as to diversify investment risks,[42] to enjoy economies of scale, to take advantage of the expertise of the investment manager, or to gain access to certain asset types which are not accessible to small investors.

Under a collective investment scheme with a trust structure, the assets are held by a trustee on behalf of the investors. Usually, an investment manager will be appointed to manage the assets, such as switching from one asset class to another. Each investor holds an undivided share of the beneficial interest in the trust assets. This trust structure ensures that investors are protected from the bankruptcy risk of the trustee or the investment manager.

2.7.2 Security trust

One common role played by trustees in banking transactions is to hold a security on behalf of bank lenders. Such transactions include secured syndicated loans and project financing. The use of the trust structure facilitates transfers of loans from one lender to another. However, unlike bond trustees who will not hold the bonds and become a bondholder, it is common for a lender, or an associate of a lender, to act as security trustee in banking transactions.[43]

2.7.3 Custodian holding

In financial markets, there are many situations where it would be beneficial to let a trustee hold assets on behalf of other parties. For example, a broker firm may purchase various

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[42] Diversification is difficult to achieve where the amount of money involved is relatively small.

[43] Obviously, this could give rise to the issue of conflict of interest. A recent example is *Saltri III Ltd v MD Mezzanine SA Sicar* [2012] EWHC 3025 (Comm) where one complaint of the junior lenders was that the security trustee, also being a senior lender, chose a course of action which was disadvantageous to the junior lenders. The court held that the security trustee's breach (if any) did not cause any loss to the junior lenders.

investment products for its clients. In most cases, it is easier and less costly for the broker firm to hold the assets for the clients, rather than for the clients to hold the assets directly. However, if the assets were held on the balance sheet of the broker, the clients would be exposed to its credit risk. Therefore, a trust structure can be set up under which a third party holds the assets on trust for the broker's clients.

A custodian holding through a trust is also widely used in financial market infrastructure. For example, in terms of bonds issued through a clearing system under a global bond structure, the global bond is held by the clearing system as a bare trustee for its accountholders.

CHAPTER 3 A COMPARATIVE OVERVIEW OF THE LAWS OF BOND TRUST IN COMMON LAW AND CIVIL LAW COUNTRIES

3.1 Introduction

> "The law ought not [to] make trusteeship so hazardous that responsible individuals and corporations will shy away from it."[1]

Most non-financial corporate bonds are issued under a trust structure. While the concept of the trust is no stranger to the common law jurisdictions, it was not recognised in most civil law countries until recently. The aims of this chapter are to offer a selective overview of the laws of bond trusts across eight jurisdictions, and to draw some useful insights.

The United Kingdom and the United States have arguably the most mature systems of financial law.[2] In addition to the domestic bonds issued in these two countries, many international bond issues are also governed by English law or US law. Parts 3.2 and 3.3 examine the law of bond trusts in the United Kingdom and the United States respectively. Part 3.4 introduces the bond trust law of Australia and New Zealand. In contrast to the "light-handed" approach to regulating bond trusts in the UK and the US, Australia and New Zealand impose onerous monitoring duties on bond trustees for publicly issued bonds. Part 3.5 offers a brief overview of the laws of bond trusts in four civil law countries, namely Germany, Japan, The Republic of Korea, and China. Part 3.6 concludes with comparisons and insights.

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1 *Dabney v Chase National Bank of City of New York* 196 F2d 668 (2nd Cir 1952) at 675, per Learned Hand J.

2 In terms of international financial transactions, English law is often chosen as the governing law even when the parties and the transactions have virtually no connection with the UK.

3.2 Bond trusts under English law

3.2.1 In general

English law neither requires the appointment of a trustee, nor comprehensively regulates the terms of bond trust deeds. The main sources of the powers and duties of a bond trustee derive from the bond trust deed and case law.

The general view is that the relationship between the bond trustee and the bondholders is a trust.[3] Accordingly, the bond trustee is subject to the general fiduciary duties of a normal trustee, such as the duty of loyalty and the duty to avoid conflict of interest.[4] In addition, bond trustees are also subject to a common law duty of care.[5]

Under the standard bond trust deed, the trustee is given wide-ranging powers, such as the power to agree to certain modifications of the trust deed or the terms of the bonds, the power to waive the issuer's breaches if the trustee is of the view that such waiver will not be materially prejudicial to the interests of the bondholders, and the power to prescribe further regulations in relation to bondholders' meetings.[6] Most importantly, upon the occurrence of an event of default, the trustee has the power to take enforcement actions against the issuer.

The trustee is generally given a very broad (sometimes absolute and uncontrolled) discretion as to the exercise of its powers. As long as the trustee "has asked itself the correct

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3 See for example Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 225–228; Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at [12.21–12.27]. For a discussion of the legal nature of bond trusts, see chapter 5 "The Contractual Nature of Bond Trusts and Security Trusts".

4 See for example Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 243–245; Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at [12.23–12.26].

5 See the text to nn 20–37.

6 Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [3.60–3.67].

question, has adopted a correct interpretation of the [c]onditions [of the bonds], has taken into account all the relevant factors and ignored irrelevant factors”,[7] the decision itself cannot be challenged unless it is “so outrageous in its defiance of reason that it can properly be categorised as perverse”.[8] However, the trustee must at least consider whether to exercise its powers.[9] For example, if the trustee has actual knowledge of the occurrence of an event of default, it will be required to properly consider whether to exercise its powers (such as serving a notice of event of default). It will not be able to “bury its head in the sand” by relying on the certificate signed by the issuer’s directors stating that no such event has occurred.[10]

In terms of the bond trustee’s duties, the key duty is that, upon the occurrence of an event of default,[11] the trustee must take enforcement actions against the issuer if it has been instructed to do so by an extraordinary resolution of the bondholder or requested to do so by the bondholders of a certain percentage (usually 20%) in nominal amount of the bonds. The bond trustee does not have any other substantive duties. In particular, it has no duty to monitor or supervise the functions of the issuer;[12] it is not obliged to notify the bondholders of the

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7 *Indofood International Finance Ltd v JP Morgan Chase NA London Branch (formally JP Morgan Chase Bank, London Branch)* [2005] EWHC 973 (Ch) at [39], per Etherton J.

8 *Ludgate Insurance Company Ltd v Citibank NA* [1998] Lloyds LR 221 at [35], per Brooke LJ (cited with approval in *Concord Trust v The Law Debenture Trust Corporation plc* [2004] EWHC 1216 (Ch) at [32]). See further Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at [12.20]; Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 209.

9 *Re Manisty’s Settlement* [1974] Ch 17 at 25.

10 Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 239.

11 Certain events (for example, a breach of negative pledge) do not constitute an event of default until the bond trustee certifies in writing that such an event is materially prejudicial to the interests of bondholders. Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 208.

12 Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 25; Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd ed, Sweet & Maxwell, 2007) at [17.017].

occurrence of an event of default, or disclose information given to the trustee by the issuer if it is confidential or price-sensitive;[13] and, apart from in respect of issue of enforcement, it has no duty to consult the bondholders before exercising its discretion.[14] The bond trustee is, however, subject to a duty of care under the common law.[15]

Standard bond trust deeds usually contain extensive protective clauses.[16] For example, a commonly seen protective provision is that the trustee, in the absence of actual knowledge to the contrary, is entitled to assume that there is no event of default if the directors of the issuer give a certificate confirming no such event has occurred. Other protective provisions include: that trustee may act on advice from lawyers, bankers or other experts, and shall not be liable for doing so even though the advice contains some error; that the trustee has no obligation to monitor the functions of the issuer and is entitled to assume that no default has occurred until and unless it has actual knowledge of such event; that the trustee has full power to determine all questions arising in relation to any provisions of the trust deed, and such determinations shall be conclusive and binding on the bondholders; and that the trustee shall have absolute and uncontrolled discretion as to the exercise or non-exercise of all of its powers, authorities, and discretions.

The relationship between the issuer and the bond trustee, and the one between the issuer and the bondholders, are both contractual.[17] The disputes between the issuer and the bond

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13 Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd ed, Sweet & Maxwell, 2007) at [17.017].

14 Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [3.117].

15 See the text to nn 20–37.

16 For examples of protective provisions, see Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [3.124].

17 Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [3.46].

trustee are dealt with under general contract or tort law. In terms of declaring an event of default, the bond trustee does not owe the issuer any contractual or tortious duty to act reasonably, or not to make an unjustified assertion of an event of default.[18] Nevertheless, the issuer could seek an interim injunction to restrain the giving of a notice of acceleration until the issue as to its validity had been settled.[19]

3.2.2 Duty of care

Duty of care of trustees in general

The duty of care is found in many branches of law, such as torts, corporation law, contract law, and trust law. The duty of care of trustees traces its roots to case law. One case often cited as an early authority for the standard of care required of trustees is *Speight v Gaunt*.[20] Mr. Gaunt, the trustee, engaged a broker to purchase securities of municipal corporations. The broker gave the trustee a forged bought-note to Mr. Gaunt, who gave the purchase-money to the broker. The broker appropriated the money for his own use and became insolvent. The court unanimously held that the trustee was not liable for the loss of trust funds. Lord Blackburn was of the view that "a trustee sufficiently discharges his duty if he takes in managing trust affairs all those precautions which an ordinary prudent man of business would take in managing similar affairs of his own."[21] While the bought-note might appear to be irregular to some experts, the trustee, as an ordinary man, was not negligent for overlooking such irregularities.[22]

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18 *Concord Trust v Law Debenture Trust Corp Plc* [2005] UKHL 27 at [36–38].

19 At [26]. For a discussion of the probability of such an interim injunction being granted, see Jean-Marc Lamontagne-Defriez and Daniel Whitehead "The House of Lords' Decision in *Concord Trust v Law Debenture Corporation plc*" (2005) 20 JIBLR 449 at 452.

20 (1883) 9 App Cas 1. See also *In re Godfrey* (1883) 23 Ch D 483.

21 *Speight v Gaunt* (1883) 9 App Cas 1 at 19, per Lord Blackburn.

22 *Speight v Gaunt* (1883) 9 App Cas 1 at 13, per Earl of Selborne LC.

A higher standard of care is required of professional corporate trustees. In *Bartlett v Barclays Bank Trust Co Ltd (No 2)*,[23] Barclays Bank Trust Co Ltd held 99.8% of shares in a property company on trust for the Bartlett family. The company suffered financial loss due to a failed investment in a property project. The High Court held that the trustee was liable. Brightman J was of the opinion that "a higher duty of care is plainly due from someone like a trust corporation which carries on a specialised business of trust management",[24] and such a trustee should be liable for a breach of trust if "it neglects to exercise the special care and skill which it professes to have."[25] In this case, because the trustee was a majority shareholder, it should have taken measures to ensure that it would receive adequate information from the board concerning the activities of the company; had the trustee done so, it would have been able to prevent the company from embarking on the failed property project.[26]

Along with the duty of care in case law, a statutory duty of care is also imposed under the Trustee Act 2000 (UK). Section 1(1) provides that a trustee

> must exercise such care and skill as is reasonable in the circumstances, having regard in particular -
>
> (a) to any special knowledge or experience that he has or holds himself out as having, and
>
> (b) if he acts as trustee in the course of a business or profession, to any special knowledge or experience that it is reasonable to expect of a person acting in the course of that kind of business or profession.

In respect of a professional trustee, the statutory duty of care is an expansion on the *Bartlett* test. Section 1(1) considers both the subjective factor (the special knowledge or

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23 [1980] 1 Ch 515.

24 At 534.

25 At 534.

26 At 534–535.

experience the trustee has or claims to have) and the objective factor (the special knowledge or experience that the trustee should have as professional trustee). In contrast, the *Bartlett* test only looks at the subjective factor. Clause 7 of Schedule 1 to the Trustee Act 2000 (UK) provides that the statutory duty of care under s 1(1) may be excluded in trust instruments. In practice, most bond trust deeds contain a provision excluding the application of the Trustee Act 2000.

Statutory restriction on exemption clauses

While both the common law duty of care may be excluded,[27] s 750(1) of the Companies Act 2006 (UK) restricts such an exemption in respect of bond trust deeds. Section 750(1) provides that

> any provision contained in—
>
> (a) a trust deed for securing an issue of debentures, or
>
> (b) any contract with the holders of debentures secured by a trust deed,
>
> is void in so far as it would have the effect of exempting a trustee of the deed from, or indemnifying him against, liability for breach of trust where he fails to show the degree of care and diligence required of him as trustee, having regard to the provisions of the trust deed conferring on him any powers, authorities or discretions."

There are different views as to whether this provision only applies to bonds issued by UK companies,[28] or if it applies to all bond issues governed by English law.[29] This issue may be inconsequential because, in practice, bond trust deeds governed by English law, whether or not

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27 *Armitage v Nurse* [1998] Ch 241 at 254, per Millett LJ.

28 Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at [12.15]; Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 4. This issue may be inconsequential because, in practice, bond trust deeds governed by English law almost inevitably include a provision that is similar to s 750(1).

29 Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 237.

the relevant issuer is an UK company, almost inevitably include a provision that is similar to s 750(1).[30]

The wording of s 750(1) (or similar contractual provisions contained in bond trust deeds) makes it clear that, while in general the trustee should be liable for negligence, the effect of the protective provisions (ie provisions granting the trustee extended powers or modifying the trustee's duties) must also be considered. Due to the extensive use of protective provisions in bond trust deeds, it is difficult to find any express duties which the trustee is subject to. This raised concerns similar to those caused by liability exemption provisions: has the balance tilted too much in favour of the trustees? In a 2002 consultation paper, the Law Commission (UK) recommended that "the courts should have the power to disapply duty exclusion clauses or extended powers clauses where reliance on such clauses would be inconsistent with the overall purposes of the trust and it would be unreasonable in the circumstances for the trustee to be exempted from liability."[31]

This proposal was met with strong opposition. The Financial Markets Law Committee (UK) pointed out that bond trust deeds are negotiated between sophisticated commercial parties with equal bargaining powers, so allowing the courts to revisit the actions of the trustees could lead to trustees being reluctant to exercise powers, or even simply not to accept trusteeship.[32] In 2006, the Law Commission (UK) abandoned the proposal because "statutory regulation of reliance on trustee exemption clauses would give rise to significant adverse consequences",[33]

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30 Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at [12.15].

31 The Law Commission (UK) *Trustee Exemption Clauses* (Consultation Paper No 171, 2 December 2002) at [4.97].

32 Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 5.

33 The Law Commission (UK) *Trustee Exemption Clauses* (Law Com No 301, 20 June 2006) at [1.13].

and instead recommended that a rule of practice should be adopted so as to raise settlor awareness of trustee exemption clauses.[34]

Duty of care of bond trustees

The common law duty of care is preserved by s 750. This duty applies to all functions carried out by the bond trustee. It is submitted, however, that it does not mean that the same degree of care and diligence is required for all functions. Instead, in respect of a particular function, the level of standard of care should depend on the parties' intention. Such intention is to be determined based on the presumed intention that can be deduced from the nature and purpose of the trustee's function in question, the relevant protective terms (if any), the level of fees charged by the trustee for performing that the function and the experience and expertise in carrying out that function professed by the bond trustee.

Some functions of the bond trustee, such as approving the form of a notice to be sent by the issuer to the bondholders, are administrative in nature. In respect of such functions, it is reasonable to assume that the standard of care required of the bond trustee is the same as, if not lower than, an ordinary corporate trustee under a traditional express trust. This assumption is further reinforced by the fact that the trustee's fee is relatively small.[35] Nor do bond trustees normally claim that they have any special expertise in carrying out such functions.

From time to time, the issuer provides certain documents, such as its annual report, to the trustee and the trustee must examine such documents. In this regard, the bond trustee is expected to apply its special skill and care in doing so.[36] Therefore, if a close examination of the

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34 At [1.22].

35 The amount of annual fees charged by a bond trustee for a bond issue varies from a few to tens of thousands of US dollars, irrespective of the issue size. In contrast, rating agencies typically charge around 0.5 per cent of the issue size. For example, in terms of a $50 million bond issue, the rating fee will be around $250,000.

36 Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at [3.116].

documents provided by the issuer would reveal a potential default but the trustee fails to examine the documents properly, such failure would constitute a breach of the duty of care.[37]

When it comes to more serious matters, such as taking enforcement actions against the defaulting issuer, it is likely that the trustee will be held to a high standard of care. This is because taking enforcement action is arguably the most important function of the bond trustee. In addition, the trustee's fee increases substantially after the occurrence of an event of default. Accordingly, it is reasonable for the bondholders to expect the trustee to apply a high standard of care post-default. In some cases, trustee corporations also claim that they possess special expertise in terms of handling post-default matters.

It seems that there has been no reported case in which the bond trustee was found to have breached its duty of care when taking enforcement actions against the issuer. This might be due to the fact that bond trustees usually take extra care and diligence when dealing with post-default matters and they work closely with their legal advisers. Therefore, it is reasonable to assume that incidence of negligence is rare in the first place. In addition, bond trustees have no duty to provide reasons for their decisions. Hence, it is difficult for the bondholders to find out whether the trustee was negligent in its decision-making. One area in which disputes do arise is where, after being instructed to take enforcement actions by the bondholders, the trustee requires the bondholders to provide a satisfactory indemnity before proceeding.

3.2.3 Indemnity

Under a standard bond trust deed, upon the occurrence of an event of default, if the bondholders instruct the trustee to take actions, the trustee may refuse to do so unless it has received an indemnity from the bondholders that is to its satisfaction. What constitutes satisfactory indemnification can be open to question.

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[37] Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 239.

In *Concord Trust v Law Debenture Trust*,[38] the court was asked to consider the scope of the liability against which a bond trustee may reasonably require to be indemnified. Under the terms of the relevant trust deed, the bondholders were entitled to, and did, appoint Mr Rymaszewski to the issuer's board. The issuer suspended him from the board. The trustee served a notice of event of default on the issuer. However, the holders of more than 30 per cent in value of the bonds requested the trustee to serve a notice of acceleration.[39] The trustee refused to do so unless the holders provided a satisfactory indemnity against not only the costs of litigation, but also the potential damages which might be claimed by the issuer for loss caused by the notice.[40] The holders issued proceedings against the trustee seeking a declaration that the trustee was obliged to give a notice of acceleration.

Lord Scott of Foscote held for the bondholders on the ground that, even assuming the notice of acceleration was wrongly served, the issuer had no cause of action against the trustee. His Lordship observed that a trustee "cannot reasonably insist on an indemnity to cover the risk unless the risk is more than a merely fanciful one."[41]

This case exposes a controversy as to current standard bond trust documentation. From the bondholders' perspective, the indemnity which the trustee is entitled to ask for should be subject to certain conditions. One commentator argued that the trustee cannot be allowed to ask for whatever indemnity they desire.[42] Otherwise, it would be able to always refuse to follow the bondholders' instruction by seeking an absurd indemnity.

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38 [2005] UKHL 27.

39 Once this notice is served, the principal of the bonds becomes immediately repayable.

40 While the trustee and the bondholders were in discussion regarding the amount of the indemnity, the issuer contended that there had been no event of default and, more importantly, a notice of acceleration would cause substantial loss to the issuer. The trustee's assessment of such loss was in the region of €1 billion.

41 [2005] UKHL 27 at [34]. The other four judges agreed with Lord Scott's opinion.

42 See generally Saptak Santra "Bondholders, Fight Back" (2010) 29 IFLR 26.

From the trustee's perspective, however, the amount of indemnity should not be subject to an objective test (for example, whether the amount of indemnity required is reasonable). It is the trustee being asked to take action on behalf of the bondholders. The amount of indemnity should be based on the potential risk perceived by the trustee. In other words, a subjective test should apply. As long as the trustee has a genuine belief that it might be exposed to certain potential liability, it should be entitled to ask for a corresponding indemnity.

It is submitted that seeking declarations from the court to the effect that the trustee would not be exposed to certain potential liability may not be the appropriate solution to this problem, as it would only lead to increased court involvement in the administration of bond trusts. A better alternative may be to modify the no-action clause in the bond trust deed to allow the bondholders to take actions where the bondholders and the trustee cannot agree on the amount of indemnity. Under the current standard no-action clause, the bondholders are entitled to take action against the issuer only after the trustee refuses to do so after receiving a satisfactory indemnity.

3.3 Bond trusts under US law

3.3.1 Historical origin of the TIA

In the mid-19th century, construction of railroads in the US was undergoing a period of explosion. A number of construction companies issued bonds mortgaged on railroads yet to be built. To facilitate the transfer of bonds, a mortgage trustee was appointed. In most cases, the trustee was an individual associated with the issuer, such as the president of the company.[43]

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[43] Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) 42 Harv L Rev 198 at 201, note 11.

Inevitably, disputes arose. By the end of the 19th century, most indenture trustees were corporations.[44]

The 1928 market crash led to the enactment of a number of securities enactments. One of these is the Trust Indenture Act of 1939 (US), which was largely based on a report provided by the Securities and Exchange Commission studying the role played by the indenture trustees.[45] The need for regulation was conveniently summarised in s 302 of the TIA. It is believed that the national public interest and the interests of retail bond investors would be adversely affected:

> …when the trustee does not have adequate rights and powers, or adequate duties and responsibilities, in connection with matters relating to the protection and enforcement of the rights of such investors; when, notwithstanding the obstacles to concerted action by such investors, and the general and reasonable assumption by such investors that the trustee is under an affirmative duty to take action for the protection and enforcement of their rights, trust indentures (A) generally provide that the trustee shall be under no duty to take any such action, even in the event of default, unless it receives notice of default, demand for action, and indemnity, from the holders of substantial percentages of the securities outstanding thereunder, and (B) generally relieve the trustee from liability even for its own negligent action or failure to act…[46]

Other reasons for regulation include conflict of interest by the trustee,[47] the absence of the duty by the issuer to provide financial information to investors,[48] misleading or deceptive

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44 Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) 42 Harv L Rev 198 at 201, note 12.

45 Securities and Exchange Commission (US) *Report on the Study and Investigation of the Work, Activities, Personnel and Functions of Protective and Reorganization Committees: Part VI Trustees and Indentures* (18 June 1936).

46 Section 302(a)(2).

47 Section 302(a)(3).

48 Section 302(a)(4).

indenture provisions,[49] and insufficient understanding of the indenture terms by the investors due to the fact that trust indentures were drafted by the issuer or underwriter.[50]

Although the Act only applies to qualified indentures,[51] its terms have been incorporated into standard indenture deeds.

3.3.2 Mere stakeholder or fiduciary?

Before the enactment of the TIA, most courts viewed the indenture trustee as merely a stakeholder,[52] while others treated it similar to a traditional trustee.[53] A middle view is that "[t]he truth of the matter is that it is in the position neither of the stakeholder nor of the ordinary trustee. To regard the corporate trustee as a mere stakeholder is to understate its responsibilities; to treat it as though it were an ordinary trustee is to overstate the extent of its duties and subject it to a standard of conduct not required by the nature of the trust."[54]

Under the TIA and similar indenture provisions of unqualified indentures, the indenture trustee's role is separated into two parts: pre-default and after-default. Until a default occurs, its duties are only administrative and are set out in the indenture. Because of the limited role of the trustee pre-default, the general view is that the trustee, before default, is not a fiduciary, other than its duty regarding conflict of interest (see below). As the court said in Meckel, "[a]n indenture trustee is not subject to the ordinary trustee's duty of undivided loyalty. Unlike the

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49 Section 302(a)(5).

50 Section 302(a)(6).

51 Indentures pursuant to which bonds are publicly offered for sale must be qualified with the SEC. TIA, s 304.

52 For example, in *Hazzard v Chase National Bank of City of New York* 159 Misc 57 at 84 (NY Sup Ct 1936), the court said that the trustee "has his rights and duties defined, not by the fiduciary relationship, but exclusively by the terms of agreement. His status is more that of a stakeholder than one of a trustee."

53 See for example *First National Fire Insurance Company v Salisbury* 130 Mass 303 (Mass 1881) at 310.

54 Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) Harv L Rev 198 at 200.

ordinary trustee, which has historic common-law duties imposed beyond those in the trust agreement, an indenture trustee is more like a stakeholder whose duties and obligations are exclusively defined by the terms of the indenture agreement."[55] In fact, since the trustee is not a fiduciary, the bond trustee may even exercise its discretionary powers under the trust indenture in such a way knowing that it would benefit the issuer at the expense of the investors, provided that this is allowed in the indenture.[56]

After default, an indenture trustee's duty becomes "more like that of a traditional trustee".[57] While exercising its rights and powers, it must use the same degree of care and skill as a prudent man would exercise under the circumstances conducting their own affairs.

It should be pointed out that, while post default, the indenture trustee is more like a traditional trustee, there is still a key difference. As to traditional trustees, the duties are mostly imposed under case law. However, "bondholders/noteholders are a distinguishable type of

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55 *Meckel v Continental Resource Co* 758 F2d 811 (2nd Cir 1985) at 816. See also *Elliott Associates v J Henry Schroder Bank & Trust Co* 838 F 2d 66 (2nd Cir 1988) at 71; Marcel Kahan "Rethinking Corporate Bonds: The Trade-off Between Individual and Collective Rights" (2002) 77 NYULR 1040 at 1063: "The term "trustee" evokes strictly enforced fiduciary duties. But an indenture trustee for a corporate bond has quite a different status and serves different functions than, say, a trustee in a traditional trust. Until the Event of Default occurs, the trustee has virtually no obligations towards the bondholders." Contrast *Becker v The Bank of New York Mellon Trust Company, NA* 172 F Supp3d 777 (ED Pa 2016) at 790: "[A]t all pertinent times… [the indenture trustee] had a duty to act in good faith with undivided loyalty toward the bondholders' interests". In this case, the court recognised that the trustee may owe extra-contractual duties under Pennsylvania state law due to its fiduciary relationship with the bondholders, and can be held liable for failing to use reasonable care to "assure that the bondholders' rights and interests were protected." At 791.

56 *Elliott Associates v J Henry Schroder Bank & Trust Co* 838 F 2d 66 (2nd Cir 1988) at 71. It has been suggested that the indenture trustee should be held to the standard of a genuine fiduciary before an issuer's default: see Martin D Sklar "The Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder?" (1989) 106 Banking LJ 42 at 43.

57 *Peak Partners, LP v Republic Bank* 191 Fed appx 118 (3rd Cir 2006) at 122; William A Johnson "Default Administration of Corporate Trust Indentures: The General Nature of the Trustee's Responsibility and Events of Default" (1970) 15 Louis ULJ 203 at 210.

beneficiary…[because they] obtain their rights from a contract, known as an indenture, which sets out a system of individual rights held separately by individual noteholders and of collective rights held by the group of noteholders or their representative, ie, the indenture trustee."[58] It has been suggested that using or allowing the use of a fiduciary characterisation may be read as the indenture trustee agreeing to assume greater discretionary obligations than are prescribed or allowed under the indenture. Therefore, the indentures trustees should not call themselves fiduciaries, because this "can prejudice indenture trusts and mislead investors and other capital market participants", resulting in greater exposure of themselves to a higher, more unlimited standard of conduct than contemplated in the indenture.[59]

3.3.3 The indenture trustee's duties and powers under the TIA

The TIA governs the offering of debt securities, and is intended to protect the rights of bondholders. Generally, the TIA applies only to those debt securities required to be registered with the SEC under the Securities Act of 1933 (US).[60] The TIA requires that the issuer "qualify" an indenture under the TIA (ie, meeting all of the requirements of the TIA). The provisions of ss 310 to 317 are deemed to be included in every qualified indenture.[61]

Section 310 specifies the eligibility and disqualification of the trustee. Section 311 provides that any collections received by the indenture trustee in its capacity as a creditor of the

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58 *Newby v Enron Corporation (In re Enron Corporation Securities, Derivative & "ERISA" Litigation)* 70 FedRServ3d 113 (SD Tex 2008) at [8].

59 Harold L Kaplan and Mark F Hebbeln "The Anglo-American Indenture – Covenant Enforcement and Bond Defaults – US Experience and Lessons from Canada and the UK" (paper presented to American Bar Association Spring Meeting, Vancouver, April 2009) at 9.

60 The TIA does not apply to trust certificates issued under securitisation structures as such certificates are not debt securities. *Policemen's Annuity Retirement Board v The Bank of New York Mellon* 775 F3d 154 (2nd Cir 2014) at 169.

61 Section 318(c). In practice, most unqualified indentures are based upon the model indentures which also contain provisions similar to the TIA.

issuer within three months prior to a payment default shall be shared with the bondholders. Section 312 requires the issuer to provide bondholders' information to the trustee; and provides for the bondholder's right to access such information. Section 313 requires the trustee to provide certain reports to the bondholders; whereas s 314 deals with the issuers' reporting obligations. Section 315 sets out the trustee's pre-default and after-default duties and responsibilities. Section 316 protects the bondholder's payment rights. Finally, s 317 provides for the trustee's power to sue the issuer for any unpaid principal or interest, and the power to file such proofs of claim in the issuer's bankruptcy proceedings.

Some of the key provisions are further discussed below.

Section 310(b): conflict of interest

Conflict of interest may arise when the indenture trustee also acts as underwriter, creditor enhancer or holder of the relevant bonds, or as a creditor to the issuer.[62] Section 310(b) provides that if the relevant debt securities are in "default", and the indenture trustee has or acquires a "conflicting interest", then, within 90 days after ascertaining that it has such conflicting interest, and if the default to which such conflicting interest relates has not been cured or duly waived or otherwise eliminated before the end of such 90-day period, the trustee shall either eliminate such conflicting interest, or resign.

The two key concepts are "default" and "conflicting interest". Default is "as defined in the indenture, but exclusive of any period of grace or requirement of notice."[63] This indicates

[62] Under the New York state common law, it has along been recognised that the indenture trustee is "at all times obliged to avoid conflicts of interest with the beneficiaries" *AMBAC Indemnity Corporation v Bankers Trust Company* 151 Misc2d 334 (NY Sup Ct 1991) at 339. See also *Elliott Associates v J Henry Schroder Bank & Trust Co* 838 F 2d 66 (2nd Cir 1988) at 73; *In re EF Hutton Southwest Properties II, Ltd* 953 F2d 963 (5th Cir 199m2) at 972; *Peak Partners v Republic Bank* 191 Fed Appx 118 (3rd Cir 2006) at 122.

[63] Section 310(b).

that the term "default" as used in s 310(b) is the equivalent for the same term as defined in the model indentures.[64]

Ten types of relationships are deemed to constitute conflicting interest, including dual trusteeship, being underwriters, having director or officer interlocks and owning of voting securities. Arguably, the most controversial conflicting interest is s 310(b)(10). Under this provision, a trustee is deemed to have a conflicting interest if "the trustee shall be or shall become a creditor of the obligor."

Previously, in some bond default cases where the bond trustee was also a creditor of the bond issuer, bondholders alleged that the trustee breached its fiduciary duties by prematurely collecting a debt owed to it by the issuer, thereby rendering the issuer insolvent.[65] Such cases prompted certain commentators to suggest that trust corporations should be prohibited from occupying a dual role as creditor of a borrower and as the indenture trustee for publicly-held bonds of the borrower.[66] In the end, s 310(b)(10) was added to the list of deemed conflicting interests by s 408 of the Securities Act Amendments of 1990 (US). However, it is important to note that s 310(b)(10) stops short of a complete ban on being a trustee-creditor. Instead, a creditor is prohibited from acting as the trustee only after a default has occurred. Accordingly,

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64 Under the Model Simplified Indenture and the Revised Model Simplified Indenture, "default" is defined as "any event which is, or after notice or passage of time would be, an Event of Default." American Bar Association, Committee on Developments in Business Financing "Model Simplified Indenture" (1983) 38 The Business Lawyer 741, s 1.01; American Bar Association, Ad Hoc Committee for Revision of the 1983 Model Simplified Indenture "Revised Model Simplified Indenture" (2000) 55 The Business Lawyer 1115, s 1.01. The equivalent term under English trust deeds is "potential event of default."

65 See for example *Dabney v Chase National Bank of City of New York* 196 F2d 668 (2nd Cir 1952); *Morris v Cantor* 390 F Supp 817 (SD NY 1975).

66 Howard M Friedman "Updating the Trust Indenture Act" (1974) 7 Journal of Law Reform 329 at 343; John P Campbell and Robert Zack "Conflict of Interest in the Dual Role of Lender and Corporate Indenture Trustee: a Proposal to End it in the Public Interest" (1977) 32 The Business Lawyer 1705 at 1707. Compare Frederica R Obrzut "The Trust Indenture Act of 1939: the Corporate Trustee as Creditor" (1976) 24 UCLA L Rev 131 at 154–159.

it can be argued that s 310(b)(10) does not provide a full solution to the trustee-creditor problem, because it is possible that a trustee/creditor may have notice of financial difficulties well before the occurrence of a default of the debt securities,[67] and may take actions to protect its interest as a creditor at the expense of bondholders.

Section 315(a): duties prior to default

The TIA draws a clear dichotomy between prior to default action and after default action. Before the event of default, the trustee's role is very limited. Section 315(a) provides as follows:

> (a) The indenture to be qualified shall automatically be deemed (unless it is expressly provided therein that any such provision is excluded) to provide that, prior to default (as such term is defined in such indenture)—
>
> (1) the indenture trustee shall not be liable except for the performance of such duties as are specifically set out in such indenture; and
>
> (2) the indenture trustee may conclusively rely, as to the truth of the statements and the correctness of the opinions expressed therein, in the absence of bad faith on the part of such trustee, upon certificates or opinions conforming to the requirements of the indenture;[68]
>
> but the indenture trustee shall examine the evidence furnished to it pursuant to section 314 to determine whether or not such evidence conforms to the requirements of the indenture.

A few comments can be made in respect of this section. First, in contrast to s 310(b), the term "default" in the context of s 315(a) has the same meaning "as such term is defined in such

67 Howard M Friedman "Updating the Trust Indenture Act" (1974) 7 Journal of Law Reform 329 at 354.

68 See for example *Peak Partners v Republic Bank* 191 Fed Appx 118 (3rd Cir 2006) at 125–126. In contrast, after default, the trustee is denied the right to rely conclusively on such certificates. William A Johnson "Default Administration of Corporate Trust Indentures: the General Nature of the Trustee's Responsibility and Events of Default" (1970) 15 St L ULJ 203 at 215.

indenture". This indicates that this term in s 315(a) is the equivalent for the term "event of default" in model indentures.[69]

Secondly, s 315(a) echoes the thinking of the pre-TIA era that the duties of the indenture trustee prior to default were strictly defined and limited to the terms of the indenture. In a number of cases, the court has consistently rejected the attempted imposition of additional duties on the trustee. For instance, it has been held that the trustee does not have the duty to communicate an opinion regarding the fairness of a reduction in the conversion price to bondholders,[70] or the duty to ensure that the issuer file accurate reports with the SEC.[71] In particular, the indenture trustee has no duty to ascertain whether a breach has occurred, so long as the trustee is not acting in bad faith;[72] the rationale being that "the trustee cannot, without subjecting itself to too great a hardship, investigate into all the affairs of the company in order to learn of every breach".[73]

Thirdly, while the trustee's prior-to-default duties under the TIA and the indenture are limited, state common law imposes two additional duties on an indenture trustee: a duty to avoid conflicts of interest with the beneficiaries,[74] and a duty to perform basic non-

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69 William A Johnson "Default administration of corporate trust indentures: the general nature of the trustee's responsibility and events of default" (1970) 15 St L ULJ 203 at 223.

70 *Browning Debenture Holders' Committee v DASA Corporation* 560 F2d 1078 (2nd Cir 1977) at 1083.

71 *Racepoint Partners, LLC v JPMorgan Chase Bank, NA* 928 NE 2d 396 (NY 2010).

72 Howard M Friedman "Updating the Trust Indenture Act" (1974) 7 Journal of Law Reform 329 at 346.

73 Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) 42 Harv L Rev 198 at 245. Cf George E Palmer "Trusteeship under the Trust Indenture" (1941) 41 Colum L Rev 193 at 208 where it was argued that there was a need of active representation of bondholders prior to default.

74 *Elliott Associates v J Henry Schroder Bank & Trust Co* 838 F 2d 66 (2nd Cir 1988) at 71.

discretionary ministerial tasks.[75] One recent example is *AG Capital Funding Partners, LP v State Street Bank and Trust Co*.[76]

In this case, the indenture trustee failed to deliver a secured indebtedness registration statement to the collateral trustee as required under a side letter. As a result, there was uncertainty as to whether the bondholders had secured creditor status. In the bankruptcy proceedings of the issuer, the bondholders settled their claims against the issuer by accepting a discounted value because of such uncertainty, and agreed to release the indenture trustee from liabilities in respect of which the issuer was obliged to indemnify. The indemnity did not cover liabilities incurred as a result of the indenture trustee's own negligence, bad faith or wilful misconduct.

The bondholders sued the trustee in contract and in tort, alleging that, had the indenture trustee delivered the secured indebtedness registration statement to the collateral trustee, they would have been able to negotiate a better settlement. The court held that "an indenture trustee owes a duty to perform its ministerial functions with due care, and if this duty is breached the trustee will be subjected to tort liability."[77] Accordingly, while the claim based on contractual breach was barred by the release, the plaintiffs' claim based on negligence was not.[78]

Section 315(b): duty to notify default

Section 315(b) states that the indenture trustee shall give the bondholders notice of all defaults known to the trustee within ninety days after the occurrence. However, except in the

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75 *NY State Medical Care Facilities Finance Agency v Bank of Tokyo Trust Co* 163 Misc2d 551 (NY Sup Ct 1994) at 559; *Semi-Tech Litigation, LLC v Bankers Trust Company* 353 F Supp 2d 460 (SD NY 2005) at 472; *Peak Partners, LP v Republic Bank* 191 Fed appx 118 (3rd Cir 2006) at 122.

76 11 NY3d 146 (NY 2008).

77 At 157.

78 The case was settled for an undisclosed amount.

case of a payment default, the trustee does not have to give notice of default provided that it determines in good faith that the withholding of such notice is in the interests of the bondholders.[79]

The indenture trustee does not breach s 315(b) as long as it has no actual knowledge of the occurrence of a default, even if its lack of knowledge of the default is due to its breach of other duties.[80] This feature, together with the trustee's heightened duties and liabilities after default, could provide incentives for the indenture trustee to choose to rely on the issuer's certificates that no default has occurred, as opposed to taking active action to investigate suspicions of a default.[81]

Section 315(c): duties after default

Arguably, s 315(c) is one of the cornerstones of the TIA. It provides that, in the case of a default, the trustee must "exercise ... such of the rights and powers vested in it by such indenture, and [must] use the same degree of care and skill in their exercise, as a prudent man would exercise or use under the circumstances in the conduct of his own affairs."[82]

The prudent man standard has been subject to certain criticism. It has been said that, because of the validity of protective clauses, "on action by bondholders against the trustee for breach of trust, the court paid lip-service to the fiduciary standard of prudence for trustees."[83]

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79 Section 315(b).

80 *Semi-Tech Litigation, LLC v Bankers Trust Co* 353 F Supp 2d 460 (SD NY 2005) at 479–480.

81 Marcel Kahan "Rethinking Corporate Bonds: The Trade-off Between Individual and Collective Rights" (2002) 77 NYULR 1040 at 1063–1064.

82 Similar provisions are also in found in s 7.01(a) of the Model Modified Indenture.

83 William A Johnson "Default Administration of Corporate Trust Indentures: The General Nature of the Trustee's Responsibility and Events of Default" (1970) 15 St Louis ULJ 203 at 211.

Another criticism of the prudent man standard is that it may encourage indenture trustees to devote their energies to avoid personal liability instead of protecting bondholders.[84] Therefore, the business judgment rule should apply to indenture trustees. The protection afforded under the business judgment rule would induce indenture trustees to take such risks calculated to maximize the value paid to bondholders post default.[85]

One interesting issue is whether there is any difference between the US prudent man and the standard of care required of English bond trustees. This issue may arise where a trustee has the option of choosing either US law or English law as the governing law of the trust deed. It is arguable that the standard of care under an English trust deed is higher than that under a US indenture,[86] because an English trustee has more expansive powers and discretions than an US indenture trustee. For example, under US law, bondholders are entitled to sue for principal and interest, whereas under English law only the trustee is entitled to take such action.

Section 316(b): prohibition of impairment of bondholders' right to payment

Section 316(b) provides that "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indemnity security, or to institute suit for the enforcement of any such payment on or after respective dates, shall not be affected without the consent of such holder." The purpose of this provision is to prohibit issuers from using collective action clauses

84 Steven L Schwarcz and Gregory M Sergi "Bond Defaults and the Dilemma of the Indenture Trustee" (2008) 59 Ala LR 1037 at 1041.

85 Steven L Schwarcz and Gregory M Sergi "Bond Defaults and the Dilemma of the Indenture Trustee" (2008) 59 Ala LR 1037 at 1057–1064.

86 Stephen Norton "The Role of a Trustee in a Default Scenario" (September 2009) Step Journal.

under which the payment rights of the minority bondholders may be impaired by the majority through the exercise of their voting rights.[87]

In recent years, s 316(b) has attracted a fair amount of attention. This is because, when a corporate bond issuer is in financial trouble, it may choose to conduct out-of-court restructurings. However, because of s 316(b), the issuer would not be able to reduce the principal amount or the interest rate of the bonds it has issued unless it could obtain the bondholders' unanimous consent. Due to the difficulty of obtaining unanimous consent, in some cases, the issuer chose to adopt the exit consent technique to circumvent s 316(b).[88] The validity of exit consents has consequently become a hotly debated topic.[89]

Compared to corporate issuers, a s 316(b) styled indenture term proves to be even more challenging for distressed sovereign issuers where numbers of bondholders can be very large – neither court-ordered restructurings nor using exit consents are available options.[90] On a number of occasions, hedge fund investors have been able to demand and receive a much better recovery compared to other bondholders by asserting their payment rights under the indenture.[91]

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87 Prior to the enactment of the TIA, there existed a conspiracy theory that "bands were using their holdings of bonds to vote through reschedulings over the heads of retail bondholders so that the wicked banks could collect their own private loans, which matured before the rescheduled bonds." Allen, Overy "Uses and Abuses of Collective Action Clauses in Sovereign Bonds" (2013) 14 Bus L Int'l 269 at 271.

88 The exit consent technique refers to an offer by a bond issuer to all the bondholders to exchange the existing bonds for new bonds or other types of securities, on the condition that the tendering bondholders must consent to a resolution which will amend the terms of the existing bonds so as to make the bonds less attractive.

89 For a detailed discussion of the issue of exit consent, see chapter 7 "Exit Consents in Debt Restructurings".

90 While the TIA does not apply to sovereign bonds, many US law governed sovereign bond indentures do contain a provision similar to Section 316(b).

91 For a discussion of the hold-out problem in sovereign bonds and possible solutions, see Jill E Fisch and Caroline M Gentile "Vultures or Vanguards?: The Role of Litigation in Sovereign Debt Restructuring" (2004) 53 E L J 1047; Robert Auray "In Bonds We Trustee: A New Contractual Mechanism to Improve Sovereign Bond Restructurings" (2013) 82 Fordham L Rev 899. Recently, the Treaty Establishing the European Stability Mechanism requires all Euro-area bonds issued after 2013 to contain provisions which

3.4 The Australia-New Zealand model

The bond markets in Australia and New Zealand are relatively small.[92] However, the bond trust laws in these two countries deserve close study, because there is a crucial difference between the Australia and New Zealand bond trust laws on the one hand, and their counterparts in the US and UK on the other. Under the Anglo-American model, the bond trustee's prior-default duties are very limited. In particular, it does not need to monitor the performance of the issuer. By contrast, in both Australia and New Zealand, the bond trustee of public bonds has statutory duties to monitor the issuer's performance to ensure that the issuer complies with the terms of the bond trust deed and is able to repay the bonds.[93] In recent years, after a number of finance company failures in both countries, bond trustees have been embroiled in legal disputes over alleged breaches of the monitoring duties.[94]

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allow the payment terms of the bonds to be amended with a majority consent, as opposed to unanimous consent.

92 As of October 2014, the total amount of bonds outstanding in the New Zealand bond market is about NZ$121 billion; and the size of the Australian bond market is around AU$ 1.5 trillion. Lauren Rosborough, Geordie Reid and Chris Hunt *A Primer on New Zealand's Capital Markets* (RBNZ Bulletin 78(3), May 2015) at 12; Guy Debelle "The Australian Bond Market" (Speech to the Economic Society of Australia, Canberra, 15 April 2014). By contrast, the US bond market size is over US$40 trillion, and the Eurobond market is over €20 trillion. SIFMA "US Bond Market Issuance and Outstanding" (from 1980 to 2016 Q3 (outstanding), 13 February 2017) <www.sifma.org>; John Glover "Europe's 20.3 Trillion-Euro Bond Market Shrinks as Banks Retreat" (25 September 2014) Bloomberg <www.bloomberg.com>.

93 Other countries with a similar bond trust regime include India (rule 18(3)(f) of the Companies (Share Capital and Debentures) Rules 2014) and Malaysia (s 78(1) of the Companies Act 1965).

94 Eg *Camilleri v The Trust Company (Nominees) Ltd* [2015] FCA 1468; *Harrison v Sandhurst Trustees Ltd* [2011] FCA 541; *LDC Finance Ltd (in rec and in liq) v Miller* [2013] NZHC 2993; *Hotchin v New Zealand Guardian Trust Co Ltd* [2016] NZSC 24.

3.4.1 Bond trusts under Australian law

During the first half of the 20th century, Australian corporate bonds were mostly issued by government-owned corporations to fund public works programmes.[95] After World War II, the corporate bond market began to shift towards a larger share of private issuance.[96] In the early 1960s, in response to a series of disastrous failures of private corporations,[97] legislative changes were introduced in the six States and the Australian Capital Territory to protect the interests of bond investors.[98] Those provisions have now been largely carried into the Corporations Act 2001 (Cth).

Summary of the statutory regime under the Corporations Act (Cth)

Chapter 2L of the Corporations Act (Cth) establishes a regime for publicly issued bonds.[99] Part 2L.1 contains the general requirements. Specifically, the issuer of retail bonds must appoint a trustee and enter into a trust deed with the trustee,[100] and the trustee holds the right to enforce

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95 Susan Black and others *A History of Australian Corporate Bonds* (Reserve Bank of Australia, RDP 2012–09, December 2012) at 7.

96 At 9.

97 One of the failed companies was Reid Murray Group, the fourth-largest Australian company at that time. At the time of its collapse, it owed bondholders almost AU$60 million.

98 See for example the Companies (Public Borrowings) Act 1963 (Vic); the Companies (Trustees for Debenture Holders) Act 1963 (Vic).

99 The term used therein is "debenture". Section 9 of the Corporations Act (Cth) defines debenture of a body as "a chose in action that includes an undertaking by the body to repay as a debt money deposited with or let to the body. The chose in action may (but need not) include a security interest over property of the body to secure repayment of the money". This definition does not accord with the public's understanding of the word "debenture". To address this concern, s 283BH restricts how borrowers may describe or refer to debentures in any document. In essence, debentures may be described as "debentures" only if they are secured. For criticism of s 283BH, see Corina Brooks (ed) *Australian Finance Law* (6th, Thomson Reuters, Sydney, 2008) at [7.310].

100 Section 283AA. For a discussion of the economic justifications for the debenture trustee, see Mark Blair and Ian Ramsay "Collective Investment Schemed: The Role of the Trustee" [1992] 1(3) Australian Accounting Review 10 at 13–14.

the borrower's duty to repay and other duties in trust for the benefit of the bondholders.[101] The bond trustee must be the Public Trustee of any State or Territory, a licensed trustee company or certain other regulated entities.[102]

Part 2L.2 and Part 2L.3 set out the duties of the issuer and the guarantor. Part 2L.4 regulates the duties of the trustee. Under s 283DA, the bond trustee must exercise reasonable diligence to ascertain whether the property of the issuer will be sufficient to repay the bonds,[103] and whether the issuer has committed a breach of the terms of the bonds, the trust deed or Chapter 2L of the Corporations Act (Cth) (the reasonable diligence duties).[104] The bond trustee needs to do everything in its power to ensure that the borrower or a guarantor remedies any such breach unless the bond trustee is satisfied that the breach will not materially prejudice the debenture holders' interests or any security for the debentures.[105]

Section 283DA(h) requires that the bond trustee must comply with any direction given to it at a debenture holders' meeting. It is not liable for anything done or omitted to be done in accordance with the direction.[106] However, the trustee does not need to follow the direction if the trustee is of the opinion that the direction is inconsistent with the terms of the bonds or the provisions of the trust deed or the Corporations Act (Cth) or is otherwise objectionable; and has either obtained, or is in the process of obtaining, an order from the Court setting aside or varying the direction.[107]

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101 Section 283AB.

102 Section 283AC.

103 Section 283DA(a).

104 Section 283DA(b).

105 Section 283DA(c).

106 Section 283DC.

107 Section 283DA(h). See for example *Permanent Nominees (Australia) Ltd, in the matter of Momentum Mortgages Ltd (Receivers and Managers Appointed) (Subject to a Deed of Company Arrangement)* [2009] FCA 1576. Compare s 210(1) of the Financial Markets Conduct Act 2013 (NZ) under which the supervisor

Under s 283DB, any provision of a bond trust deed is void if it would have the effect of exempting a trustee from liability for breach of s 283DA, unless it releases the trustee from liability for something done before the release is given, or the release is approved by a 75% majority of the bondholders.

Part 2L.5 contains provisions regarding bondholders' meetings. Part 2L.6 imposes civil liability for breach of Chapter 2L. Part 2L.7 grants certain powers to ASIC, and Part 2L.8 confers a broad remedial and protective jurisdiction to the court.[108]

A drafting error in s 283F(1)?

Section 283F(1) creates a broad liability for damages. It states:

> (1) A person who suffers loss or damage because a person contravenes a provision of this Chapter may recover the amount of the loss or damage from:
>
> (a) the person who contravened the provision; or
>
> (b) a person involved in the contravention.
>
> *This is so even if the person did not commit, and was not involved in, the contravention* (emphasis added).

The last sentence seems difficult to understand, because it directly contradicts the preceding provisions which state that the only person liable to pay compensation is either the person who committed the breach, or the person who is involved in the breach. This sentence

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may apply for a court order for not having to comply with a special resolution of the bondholders if compliance would be objectionable (for example, because it would be oppressive to the minority).

108 For discussions of the court's powers under Part 2L.8, see *Australian Securities and Investments Commission v Bridgecorp Finance Ltd* [2006] NSWSC 836 at [14]; *Perpetual Trustees WA Ltd v Elderslie Finance Corporation Ltd* [2008] FCA 1068 at [31]; *Australian Executor Trustees Ltd v Provident Capital Ltd* (2012) 203 FCR 461 at [75]; *The Trustee Company (Nominees) Ltd v Southern Finance Ltd, in the matter of Southern Finance Ltd* [2012] FCA 1339 at [16]; *The Trustee Company (Nominees) Ltd v Gippsland Secured Investments Ltd* [2013] FCA 1393 at [17]–[23]; *Trust Company (Nominees) Ltd, in the matter of Angas Securities Ltd v Angas Securities Ltd* [2015] FCA 772 at [76]–[85].

also appears in ss 670B and 729. However, in each of those two sections, the person liable to pay compensation is referred to in a table contained in the relevant section. It is possible that the person identified in the table is not the person who committed the breach or was involved in the breach. Therefore, it is necessary to clarify that the person referred to in the table is liable to pay compensation "even if the person did not commit, and was not involved in, the contravention". By contrast, under s 283F, subsections (a) and (b) have made it clear that the person liable for compensation is either the person who committed the breach, or was involved in the contravention. Accordingly, the last sentence is likely to be a drafting error and should be amended for deletion.

Litigations and regulatory reform

It has been said, in obiter, that s 283DA requires the bond trustee to actively monitor and take steps within their powers to understand the financial health of the issuer.[109] In addition, ASIC believes that monitoring the financial position and performance of the bond issuer generally, and the issuer's performance against its disclosure against the benchmarks in its prospectus, is included in the reasonable diligence duties.[110] Given the broad scope of the reasonable diligence duties, it is almost inevitable that, when a bond issuer defaults, the bond trustee will be accused of failing to comply with s 283DA. In recent years, bondholders and the Australian Securities and Investments Commission (ASIC) have brought numerous actions

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109 *Australian Securities and Investments Commission v Bridgecorp Finance Ltd* [2006] NSWSC 836 at [20].

110 ASIC *Debentures and Notes: Improving Disclosure for Retail Investors* (RG 69, February 2012) at [RG 69.115].

against bond trustees based on alleged breach of the reasonable diligence duties. Some of these cases are now settled,[111] while others are continuing.[112]

In February 2013, ASIC released Consultation Paper 199, seeking feedback on reform proposals to strengthen the regulation of companies that issue bonds to retail investors.[113] Under the proposals, trustees will be expressly required to regularly express a view in writing regarding the issuer's financial position and on-going viability.[114] Furthermore, trustees will need to exercise reasonable diligence to ensure that the material information provided by the issuer in the prospectus is correct and current.[115] If implemented, this proposal would represent a major expansion of the role of bond trustee because, as a general rule, bond trustees are not responsible for the correctness of the contents of issuer disclosure documents. That responsibility is more appropriately placed on the issuer and its directors.

3.4.2 Bond trusts under New Zealand law

In 1966, following the legislative changes introduced in Australia regarding bond trusts, the Companies Act 1955 (NZ) was amended to provide for the mandatory appointment of a trustee for publicly issued bonds. Similar to its Australian counterpart, the Act required the bond trustee to exercise reasonable diligence to determine whether or not the issuer had

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111 Eg the claims against the trustees of Westpoint group (settled for AU$13.5 million); against Australian Capital Reserve Limited (settled for AU$ 25 million, *Camilleri v The Trust Company (Nominees) Ltd* [2015] FCA 1468), and Fincorp Investments Limited (settled for AU$29 million, *Harrison v Sandhurst Trustees Ltd* [2011] FCA 541).

112 Eg the cases against Australian Executor Trustees Limited (*Smith v Australian Executor Trustees Ltd*; *Creighton v Australian Executor Trustees Ltd* [2016] NSWSC 17) and Sandhurst Trustees Limited (*Sandhurst Trustees Ltd v Clarke* [2015] FCAFC 21).

113 ASIC *Debentures – Reform to Strengthen Regulation* (CP 199, 13 February 2013).

114 At 24.

115 At 27.

committed any breach of the terms of the trust deed; and whether or not the issuer's assets were sufficient to discharge the amounts owing under the bonds.

From around 2000 to 2005, the number of finance companies grew rapidly in New Zealand. Their expansion was mostly funded by issuing bonds to retail investors. During 2006 to 2011, over sixty finance companies collapsed, affecting 200,000 investors and over NZ$9 billion funds. While the public anger and regulatory actions were mainly targeted at directed at the directors and managements of those failed companies, the role played by bond trustees also drew heavy criticism[116] and much litigation.[117]

Under the Financial Markets Conduct Act 2013 (NZ), the regulatory regime of bond trust was revamped and strengthened – stringent monitoring duties and heightened conduct standards have been imposed on bond trustees.[118]

3.5 Bond trusts in civil law jurisdictions

In common law countries, the general view is that a bond trust is a type of trust, albeit a special one.[119] The backbone of the law of trusts is the separation of legal and beneficial

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116 Commerce Committee 2007/08 *Financial Review of the Ministry of Economic Development* Appendix B (2009) <www.parliament.nz>.

117 Similar to the situation in Australia, many of such cases were settled before trial. A recent example is a case brought by the receivers of failed finance company Capital+Merchant Finance Limited against the bond trustee Perpetual Trust Limited. A settlement was reached on the day before the scheduled first hearing. Campbell Gibson "Capital Merchant Finance and Perpetual Trust case settled" *The National Business Review* (New Zealand, 14 November 2016). See further Benjamin Liu "Why are Bond Trustees Sued More often in New Zealand? An Analysis of the Duty to Monitor under New Zealand Law" (2016) 31 JIBLR 75.

118 For detailed discussion of the new NZ bond trust regime, see chapter 4 "From "Bond Trustee" to "Supervisor": A Critical Review of the Bond Trust Regime under the Financial Markets Conduct Act 2013".

119 For detailed discussion of the nature of bond trusts, see chapter 5 "The Contractual Nature of Bond Trusts and Security Trusts".

ownership. Historically, continental civil law jurisdictions have been hostile to the idea of a trust, because the separation of legal and beneficial ownership is in direct conflict with the concept of unitary ownership, which is a cornerstone of the civil law on property. However, in recent years, mostly due to the growing importance of the trust as an instrument of international finance,[120] the concept of trust has gradually gained acceptance in continental civil law jurisdictions. For example, in Germany, a concept similar to the common law trust now exists in a number of areas.[121] France has also recently passed the French statute of 19 February 2007, creating the *fiducie*, the French equivalent of the concept of trust in common law systems.[122]

Interestingly, unlike European civil law countries, trust ideas are embraced in civil law jurisdictions of Asia with relative ease. As early as in 1922, Japan enacted the Trust Act and the Trust Business (Regulations) Act.[123] South Korea and Taiwan also passed trust laws in 1961 and 1995 respectively. In 2001, China became the latest Asian country to adopt trust law.[124]

The trust laws in the major civil law countries share a number of common features. For instance, only licensed companies are allowed to conduct trust-related business, and the trust

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120 Jacopo Crivellaro "Editorial: Special Issue on Trust Law" (2012) 18(2) The Columbia Journal of European Law Online 2.

121 On the German *Treuhand* generally, see Johannes Rehahn and Alexander Grimm "Country Report: Germany" (2012) 18 Colum J Eur L 93.

122 Loi no 2007–211 of 19 February 2007. See Martin Gdanski and Tara Pichardo-Angadi "The French law on Fiducie and its Application to Banking and Finance Transactions" (2007) 22 JIBLR 434. For a comparison between the trust concept in French law and the American trust, see Valerio Forti "Comparing American Trust and French *Fiducie*" (2010) 17 Colum J Eur L 28. For a comparative discussion of the laws of bond trusts in the United States, France, and Luxemburg, see Frederic C Rich "International Debt Obligations of Enterprises in Civil Law Countries: The Problem of Bondholder Representation" (1981) 21 Virginia J Int'l L 269.

123 Munehide Nishizawa "The Status of the Trust under Japanese Law" (1990) 1 IBLJ 1990 at 7.

124 See generally Rebecca Lee "Conceptualizing the Chinese Trust" (2009) 58(3) ICLQ 655.

structure is used mostly in commercial transactions. Furthermore, unlike common law jurisdictions, the settlor in civil law countries continues to have a number of rights against the trustee after the creation of the trust, such as the right to request the trustee to provide explanations in respect of its activities.[125] In addition, civil law countries focus on express trusts, requiring that all trusts have to be set up in writing. Other trust law concepts in common law countries, such as resulting trusts and constructive trusts, have yet to be adopted.

Set out below is a brief introduction of the law of bond trust in each of four civil law countries: Germany, Japan, Republic of Korea, and China.[126]

3.5.1 Germany

Prior to 2009, bonds were governed by the Statute Concerning the Common Rights of the Holders of Debt Securities of 4 December 1899.[127] This statute had a number of problems. In particular, it allowed bondholders to resolve to reduce the interest rate or defer payments, but not reduce the principal.[128]

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125 See for example Trust Law 2001 (CN), art 20.

126 These four countries have been selected due to the importance of their local financial markets and the sizes of their local economies.

127 Gesetz betreffend die gemeinsame Rechte von den Inhabern von Schuldverschreibungen vom 4. Dezember 1899.

128 Angelo Lercara and Michael H Meissner "Reform of the German Bond Act and its Impact on the German Debt Capital Market" (2010) 25 JIBLR 298 at 299.

In 2009, a new German bond law was enacted.[129] Under the new bond law, bondholders are allowed to reduce the principal of the bonds through bondholders' resolutions.[130] A common representative for the bondholders can be appointed either before or after the bond issue. The common representative must follow the instructions of the bondholders. The duties of the common representative are to be specified in the bond terms.[131] While the common representative is liable to the bondholders for the proper performance of its duties, its liability may be limited by the terms of the bonds to 10 times of its annual remuneration except in cases of intentional misconduct or gross negligence.[132]

3.5.2 Japan

Japan is the first Asian civil law country to adopt a trust law.[133] In 1905, due to companies needing to issue bonds in the London market to fund the post-war constructions after the Russo-Japanese war, Japan passed the Secured Bond Trusts Act (JP), which recognised the trust concept for this singular purpose.[134] In 1922, the Japanese Trust Act (JP) was passed, which

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129 Gesetz zur Neuregelung der Rechtsverhältnisse bei Schuldverschreibungen aus Gesamtemissionen und zur verbesserten Durchsetzbarkeit von Ansprüchen von Anlegern aus Falschberatung vom 31. Juli 2009 (translation: Statute to Reform Collective Bond Offerings and Enforcement of Investors' Claims of 31 July 2009).

130 Sections 4 & 5(1); Jason Grant Allen "More Than a Matter of Trust: the German Debt Securities Act 2009 in International Perspective" (2011) 7 CMLJ 55 at 62 and 71.

131 Jason Grant Allen "More Than a Matter of Trust: the German Debt Securities Act 2009 in International Perspective" (2011) 7 CMLJ 55 at 80.

132 Angelo Lercara and Michael H Meissner "Reform of the German Bond Act and its Impact on the German Debt Capital Market" (2010) 25 JIBLR 298 at 303.

133 Ian Gzell "The Origin and Development of the Trust in Asia" (STEP, Sydney, 23 June 2010).

134 Hiroto Dogauchi "Trusts in the Law of Japan" International Goods and Services Transactions Group <www.law.tohoku.ac.jp>; Munehide Nishizawa "The Status of the Trust under Japanese Law" (1990) 1 IBLJ 7 at 9.

has now been replaced by the Trust Act 2006 (JP). The trust structure in Japan is mostly used in commercial transactions, such as in loan trusts and money trusts.[135]

In 1993, the Commercial Code was amended to replace the bond trustee system with the commissioned company system.[136] While commissioned companies were not legally liable for the repayment of the bonds, in practice they often chose to repay when the bond issuers defaulted.[137]

In 2005, the company law provisions were lifted from the Commercial Code and inserted into the Companies Act 2005 (JP). Under the 2005 Act, an issuing company must appoint a commissioned company[138] unless the denomination of the bonds is more than JPY 100 million.[139] The commissioned company must be a bank, a trust company, or other person authorized by the Ministry of Justice.[140] The commissioned company must perform its duties

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135 A loan trust is an arrangement under which the trustee accepts money from investors and uses it to lend to business borrowers. This is similar to wealth management products sold in the Chinese market. A money trust is similar to a loan trust but the trustee invests the money in securities instead of loans. Hideki Kanda "A Trust for Commercial Use in Japan: An Unexpected Winner in the Race among Organizational Form" in Unidroit (ed) *Eppur si muove: the age of uniform law. Essays in honour of Michael Joachim Bonell to celebrate his 70th birthday* (Unidroit, Rome, 2016) 599 at 600.

136 Suk Hyun "The Trustee System, and Revitalizing the Corporate Bond Market" Korea Capital Market Institute (20 September 2011) <www.kcmi.re.kr> at 3; ASEAN+3 Bond Market Forum *Japan Bond Market Guide* (2012) at 29.

137 J Robert Brown Jnr "Bond Markets in Japan" in Helen Parry, Tamasin B Little and Michael Taylor (ed) *Bond Markets: Law and Regulation* (Sweet & Maxwell, London, 1999) at 209; Jonathan A Battern and Peter G Szilagyi "Impediments to Corporate Bond Market Development in Japan" (10 April 2003) <www.researchgate.net> at 19.

138 Under the Companies Act (JP), the Japanese term used is '社債管理者', to which its official English translation is 'bond manager'. However, it seems that market participants in general continue to use the term 'commissioned company' in the English documentation, probably to avoid confusion with the other meaning of 'bond manager', ie an asset manager who manages a bond portfolio.

139 Companies Act 2005 (JP), art 702.

140 Article 703.

in a fair and sincere manner on behalf of the bondholders, and manage the bonds with the due care of a prudent manager.[141] The commissioned company will be liable to compensate bondholders' losses if the commissioned company breaches its duties.[142]

3.5.3 Republic of Korea

The concept of trust was introduced into the legal system in South Korea under the Trust Act 1961 (KR). Section 8 of Part III, Chapter IV of the Korean Commercial Act 1963 (KR) regulates corporate bonds issued by stock companies.[143] In 2012, an "indenture trustee system" was formally introduced under the revised Commercial Act (KR).[144] Bond issuers are not obliged to appoint an indenture trustee.[145] However, if they choose to do so, they can only appoint accredited financial institutions, such as banks, trust companies, and securities companies, to act as the indenture trustee. The indenture trustee owes fiduciary duties to the bondholders, and must manage bonds with honesty and sincerity.[146]

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141 Article 704.

142 Article 710.

143 In Korea, the types of companies include stock companies (Chusik Hoesa), partnership companies (Hapmyong Hoesa), limited partnership companies (Hapja Hoesa), and limited liability companies (Yuhan Hoesa). A limited liability company may not have more than 50 shareholders and is not allowed to issue bonds.

144 Prior to 2012, the practice of appointing a trustee already existed in the Korean corporate bond markets. See Changyong Rhee, Sunghwan Shin and Youngshin Yoon "Designing the Governance Structure of Corporate Bonds in Korea: Empirical Study on Corporate Bond Indentures in Korea" (paper presented to 2003 KDI Conference Corporate Governance and Capital Market in Korea, Seoul, December 2003) at 21. For a general overview of the Korean bond market, see Korea Financial Investment Association *Capital Market in Korea* (2013) at 69–121.

145 The issuing company may choose to adopt the commissioned company system whereby a company is commissioned to act for the issuer during the subscription stage but act for bondholders after the issue of the bonds. For a comparison of the two systems, see ASEAN+3 Bond Market Forum *Republic of Korea Bond Market Guide* (2012) at 122–125.

146 At 123.

In practice, most underwriters take on the role of trustee for a nominal fee or no fee, because the trustee function is regarded as an additional service provided by the underwriter.[147]

3.5.4 China

The Chinese legal system is based primarily on the continental civil law model.[148] In particular, the General Rules of the Civil Law of the People's Republic of China 2017 (CN) bears a certain resemblance to the German Civil Code of 1900. Prior to 2001, the trust was not a recognised legal concept under the Chinese law.[149] In 2001, the Trust Law of China was enacted.[150] Under the Trust Law, a trustee manages the trust assets in accordance with the settlor's instructions for the benefit of the beneficiary.[151] The trust assets are segregated from other assets of the settlor and the trustee's own assets.[152] Only licensed entities may conduct trustee business.[153]

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147 Changyong Rhee, Sunghwan Shin and Youngshin Yoon "Designing the Governance Structure of Corporate Bonds in Korea: Empirical Study on Corporate Bond Indentures in Korea" (paper presented to 2003 KDI Conference Corporate Governance and Capital Market in Korea, Seoul, December 2003) at 22–24.

148 Judicial precedents are not enforceable in China. However, the Supreme People's Court of China enjoys a certain degree of legislative power through issuing rules of judicial interpretation on various legal issues. Such rules are binding on the lower courts.

149 While some local companies' names did contain the word "trust" (信托), this word was used in the meaning of "belief in the reliability", rather than its settled legal meaning under common law.

150 For a general introduction to the trust law in China, see Lusina Ho *Trust Law in China* (Sweet & Maxell Asia, Hong Kong, 2003). For a comparative study of Chinese trust law, see Zhenting Tan "Perfecting the Chinese Law of Trusts – A Critical and Comparative Study of the Australian and the Chinese Law of Trusts" PhD Thesis.

151 Trust Law of the People's Republic of China 2001 (CN), art 2.

152 Articles 15 and 16. The Trust Law is vague on whether the beneficiary is the legal owner of the trust property. This uncertainty is likely to present a challenge to the future development of trust law and practice in China. See Rebecca Lee "Conceptualizing the Chinese Trust" (2009) 58(3) ICLQ 655 at 663–668; Ruiqiao Zhang "Trust Law of China and Its Uncertainties: Examination of the Rights and Obligations of Trust and Ownership of Trust Property" (2015) 10 Nat'l Taiwan ULJ 45 at 66–70.

153 Trust Law of the People's Republic of China 2001 (CN), art 4.

On 15 January 2015, the China Securities Regulatory Commission issued the Administrative Measures for Issuing and Trading Corporate Bonds (CN) (the Measures). The Measures contain provisions regarding issuer qualification, information disclosure, and governance. In particular, a trustee must be appointed for all bond issues.[154] The bond trustee must exercise due diligence and discharge its duty in a fair and just manner.[155] In terms of publicly issued bonds, the trustee must (a) continuously monitor the issuer's creditworthiness, the security assets and the implementation of the credit enhancement measures; monitor the use of issue proceeds; investigate the issuer's ability to repay the bonds; ensure the issuer complies with its disclosure requirements; require the issuer to provide additional guarantees where the issuer is likely to default; and take legal actions and participate in the restructuring or bankruptcy procedures upon the instruction by the bondholders.[156] In terms of privately issued bonds, the trustee shall perform its duties in accordance with the trust agreement.[157]

In recent years, the PRC bond market has become the largest among Asian emerging economies, reaching US$3 trillion in 2016.[158] The number of defaults has also risen sharply.[159] There are reasons to suspect that, similar to the situations in Australia and New Zealand, the PRC bond investors will increasingly take legal action against the bond trustee after a bond default on the ground that the bond trustee has failed to properly monitor the issuer's default

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154 Administrative Measures for Issuing and Trading Corporate Bonds 2015 (CN), art 48.

155 Article 49.

156 Article 50.

157 Article 52. For discussion of the bond trustee's legal standing in court, see Jiefeng Lu and Liu He "关于完善债券持有人利益保护规则的思考与建议" (2016) 6 China Securities 30 at 32–34 (translation: Thoughts and Suggestions on Improving the Protection of Bondholders' Interests).

158 Lianting Tu and Judy Chen "It's All Suddenly Going Wrong in China's $3 Trillion Bond Market" Bloomberg News (19 April 2016) <www.bloomberg.com>.

159 For a list of recent defaults or near defaults, see Wojciech Maliszewski and others "Resolving China's Corporate Debt Problem" (IMF Working Paper, WP/16/203, October 2016) at 30.

risk.[160] Another potential issue is conflict of interest. According to Article 47 of the Measures, bond underwriters can, and in practice do, act as bond trustee. When a bond issuer defaults or is about to default, the issue of conflict of interest may arise if the bond trustee itself is also a creditor due to its transactions with the bond issuer in its capacity as underwriter.[161]

3.6 Conclusion

The review of bond trust law across common law jurisdictions reveals an interesting dichotomy. On the one hand, the Anglo-American model takes a light-handed approach to the regulation of bond trustee's duties. On the other hand, the Australia-New Zealand model imposes onerous monitoring duties on the bond trustees. The effectiveness of such an approach is doubtful.[162]

To address this tension, a number of options have been proposed, such as giving the bond trustee more powers, and encouraging active participation by bondholders through bondholder committees. In the US context, it has been suggested that the business judgement rule should be applied to bond trustees, to encourage them to maximize the value paid to bondholders after default by taking on calculated risks. Probably there is no one-size-fits-all solution, and drafters have to carefully consider how to define the trustees' powers and duties in trust instruments in the light of the characteristics of the relevant bond issue. While any deviation from the standard

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160 There has been at least one case in which the bondholders sued the bond trustee. Wei Huo "经济新常态下的债券违约现状评析" (24 November 2016) Zhong Lun <www.zhonglun.com> (translation: An analysis of bond defaults under the new economic norm"). The proceeding may have been withdrawn, as the bondholders have received full payment under the restructuring plan. Jingfei Wu and others "太阳照常升起：ST 超日重整案例分析" (7 October 2016) <www.yuanqingsuan.com> (translation: The sun rises as usual: An analysis of the restructuring of Shanghai Chaori Solar Energy Science & Technology Co, Ltd).

161 LI Li "从"云峰债违约"谈债券受托人的利益冲突问题" (12 May 2016) Caixin <www.caixin.com> (translation: Bond Trustee's conflict of interest in the default of Yunfeng bonds).

162 See chapter 4 "From "Bond Trustee" to "Supervisor": A Critical Review of the Bond Trust Regime under the Financial Markets Conduct Act 2013".

provisions involves the potential risk of leading to unintended results, in some cases, they may be necessary to meet the particular commercial requirements of the relevant parties.

As for Asian civil law countries, while the wording of the relevant statutory provisions is, to some degree, similar to the reasonable diligence duties under Australian and New Zealand law, how the local courts will interpret these provisions is yet to be seen.

CHAPTER 4 FROM "BOND TRUSTEE" TO "SUPERVISOR": A CRITICAL REVIEW OF THE BOND TRUST REGIME UNDER THE FINANCIAL MARKETS CONDUCT ACT 2013

4.1 Introduction

Since the late 1980s, corporate bond[1] markets have started to emerge and develop in New Zealand.[2] Adopting the common practice of other capital markets, most corporate bonds in New Zealand are issued under a bond trust structure.[3] Under a bond trust, the issuer appoints a trustee company to act as a trustee on behalf of the bondholders. Generally speaking, the role of a bond trustee is threefold: monitoring, granting modifications, waivers and other consents, and enforcement.[4] The key advantage of having a bond trustee in the bond structure is that it provides a solution to the collective action problem which the bondholders would face if they had to act individually.[5]

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1 In this chapter, the term "corporate bond" refers to debt securities issued by companies, as distinct from debt securities issued by governments or banks. For the purposes of this chapter, the terms "bond" and "debt securities" are used interchangeably, and include debentures, bonds or notes, whether secured or unsecured.

2 Simon Tyler *The New Zealand Corporate Bond Market* (Reserve Bank of New Zealand, BIS Papers No 26, 2005) at 129.

3 Occasionally, a company may issue bonds only to a few institutional investors; the bonds in such cases may be issued under a deed poll, rather than via a bond trust.

4 Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 17–21.

5 For further discussion of the advantages and disadvantages of bond trustees, see Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd ed, Sweet & Maxwell, 2007) at [16.002–16.005]; Margery A Colloff "The Role of the Trustee in Mitigating Fraud in Structured Financings" (2005) 10(4) The Journal of Structured Finance 73. The importance of bond trustees is also shown in insolvency cases where the relevant bankrupt issuer not having appointed a trustee resulted in the court appointing a trustee to act as the representative of all bondholders. See Kyong Lee and Karkus Heidinger "Bondholders in Insolvency Proceedings against an Austrian Issuer – the Maculan Case" (1998) 13 JIBL 118.

Until a few years ago, cases involving disputes between a bond trustee and the bondholders were uncommon in New Zealand.[6] The lack of judicial activity in this field has likely been due to the continuation of favourable financial conditions rather than to the settled state of the law. Indeed, since finance companies started to collapse in 2006, the investors who purchased bonds issued by those companies have turned their anger and frustration towards the company directors, the auditors and, unsurprisingly, the bond trustees.[7]

This chapter examines the duties and powers of bond trustees under New Zealand law.[8] Given the ongoing litigation against bond trustees and the approaching expiry date (30 November 2016) of the two-year transition period under the Financial Markets Conduct Act 2013 (NZ) (the FMC Act),[9] this analysis is particularly timely.

This chapter argues that the monitoring duties imposed on bond trustees are unduly onerous and are therefore unlikely to achieve their purposes. In fact, neither English law nor United States law impose such duties on bond trustees.[10] However, given the relatively high percentage of retail investors in the New Zealand bond markets,[11] it is necessary to have a

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6 Negligence claims against bond trustees are often settled before the judgment. See for example *Fletcher v National Mutual Life Nominees Ltd* [1990] 1 NZLR (HC).

7 To some extent, this resembles the public outcry against bond trustees in the United States after the 1929 financial crisis. See Efrat Lev, Adv "The Indenture Trustee: Does it Really Protect Bondholders?" (1999) 8 U Miami Bus L Rev 47 at 52–54.

8 Academic research is lacking in this area. To the best of the author's knowledge, only one book on bond trusts has been published in New Zealand: Geoffrey Fuller *The Law and Practice of Debenture Trust Deeds in New Zealand* (Inventas Media Ltd – Law Press, Wellington, 1996). During 2010–2013, the New Zealand Law Commission conducted a comprehensive review of trust law. Bond trusts were covered only briefly in the review.

9 After 30 November 2016, the statutory provisions of the FMC Act regarding bond trusts will become mandatorily applicable to all regulated bond issues in New Zealand.

10 See the text to nn 42–45.

11 See the text to nn 133–136.

monitoring agent to protect the interests of retail bond investors. It is proposed that the Financial Markets Authority (the FMA) sits in a more fitting position to perform this role.

Part 4.2 of this chapter outlines the regime for bond trusts under the Securities 1978 (NZ) (the Securities Act), followed by a short account of the collapse of finance companies during 2006–2011 and the fall-out thereafter. Part 4.3 introduces the new regime under the FMC Act. Part 4.4 draws on cases in New Zealand and in other jurisdictions (such as the United Kingdom and the United States) to critically examine the meaning, application and implications of the relevant key provisions of the FMC Act. Part 4.5 proposes that the FMA should act as the supervisor in respect of all retail bonds offered in the New Zealand market. Part 4.6 offers concluding comments and practical advice to trustee companies.

4.2 The previous bond trust regime

4.2.1 Origin

The origin of the New Zealand statutory regime for publicly issued bonds can be traced back to the Companies Amendment Act 1966 (NZ), which added four sections to the Companies Act 1955 (NZ).[12] Under these sections, if the bonds were to be issued to the public, a trustee had to be appointed.[13] The bond trustee was subject to, among others, two monitoring duties: it had to exercise reasonable diligence to ascertain (1) whether or not the issuer had committed any breach of the terms of the trust deed, and (2) whether or not the assets of the issuer were sufficient to discharge the amounts of the bonds.

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12 This was following similar legislative changes introduced in Australia after the collapse of the Reid Murray Group. See s 3 of the Companies (Public Borrowings) Act 1963 (Vic). For the background, see Geoffrey Sawer "Federal-State Co-operation in Law Reform: Lessons of the Australian Uniform Companies Act" (1963) 4 MULR 238 at 239; PJ McKinlay "Need for Legislative Control over Public Debenture Borrowing" [1966] NZLJ 59.

13 Section 95A of the Companies Act 1955 (NZ), as inserted by s 5 of the Companies Amendment Act 1966 (NZ).

During the late 1970s to the early 1980s, in the midst of deregulation in the financial system in New Zealand, the regulation of public offerings of securities was moved from the Companies Act 1955 (NZ) to the newly enacted Securities Act.[14] The regime remained largely unchanged: appointment of a trustee for publicly issued debt securities continued to be mandatory,[15] and the two monitoring duties were preserved, albeit as contractual terms mandatorily implied into bond trust deeds rather than as statutory duties.[16] The monitoring duties are ultimately carried forward into the FMC Act.

While the statutory regime for bond trusts has been in place for 50 years, New Zealand bond trustees, like their counterparts in other countries, have managed to stay away from the spotlight until recently. Yet, the widespread collapse of finance companies between 2006 and 2011 has manifested a fierce debate about the role of bond trustees.

4.2.2 Failure of finance companies

In the first half of the 2000s, finance companies grew rapidly in New Zealand, fuelled by a strong local economy and increasing real estate prices. Unfortunately, their financial positions started to deteriorate in 2006 due to shabby corporate governance, drying-up liquidity and a deepening economic downturn. In mid-2006, National Finance 2000 Ltd, Provincial Finance Ltd and Western Bay Finance Ltd were the first finance companies to collapse. In 2007, Bridgecorp Ltd, with a total outstanding deposit liability of $570 million, was placed in

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14 The Act, although passed in 1978, became effective only after the Securities Regulations 1983 was put in place.

15 Securities Act, s 33(2).

16 Under s 45 of the Securities Act, the contents of trust deeds were deemed to contain all clauses that were prescribed in regulations made under the Securities Act. Such clauses were contained in sch 5 to the Securities Regulations 1983, the predecessor of sch 15 to the Securities Regulations 2009 (as amended in 2011 by the Securities Amendment Regulations (No 2) 2011) [the 2009 Regulations].

receivership. By 2011, the total number of failed finance companies reached 67,[17] affecting 200,000 investors and over $9 billion of funds.[18]

The consequences of the finance company collapse have been serious: both the Serious Fraud Office and the FMA conducted investigations and brought criminal actions against certain directors of the failed finance companies.[19] As to bond trustees, they have been sued by bond investors,[20] by the FMA through its step-in power provided in s 34 of the Financial

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17 For a complete list of the failed finance companies, see JDJL Ltd <www.interest.co.nz/saving/deep-freeze-list>.

18 For general discussion, see Christina Chiang "The Financial Crisis in New Zealand: An Inconvenient Truth" (paper presented to the 2010 Auckland Region Accounting Conference, Auckland, 26 November 2010); WR Wilson, LC Rose and JF Pinfold "Examination of NZ Finance Company Failures: The Role of Corporate Governance" (February 2010) Management Online Review 1; Noel Yahanpath and John Cavanagh "Causes of New Zealand Finance Company Collapses: A Brief Review" (August 2011) Social Science Research Network <www.ssrn.com>; Commerce Committee *Inquiry into Finance Company Failures* (October 2011) <www.parliament.nz>.

19 Arguably, not all convictions are justified. For example, the conviction of the four former directors of the failed finance company Lombard Finance and Investment Ltd is particularly controversial. See Edmund W Thomas "Manifestly Unjust: the Conviction and Criminalisation of Honest Men" (2013) 19 NZBLQ 178.

20 See for example *LDC Finance Ltd (in rec and in liq) v Miller* [2013] NZHC 2993, in which Associate Judge Matthews allowed investors to bring representative proceedings against, among others, Perpetual Trust Ltd [Perpetual Trust] as the bond trustee. The trial was due to begin in July 2016 but was settled before the trial began. See Hamish Fletcher "LDC Finance Accused of Being Reckless" *The New Zealand Herald* (online ed, Auckland, 14 January 2016); Hamish Fletcher "LDC Finance Liquidator Reach $3.8 million Settlement" *The New Zealand Herald* (online ed, Auckland, 13 June 2016).

Markets Authority Act 2011 (NZ) (the FMA Act),[21] by company directors for contribution claims,[22] and even by bond issuers.[23]

A report produced by the Registrar of Companies heavily criticised the role played by bond trustees in the collapse of the finance companies.[24] The Registrar pointed out that some trustees were slow to detect breaches of trust deed terms and to notice the development of adverse financial issues. This was further exacerbated by weak trust deed covenants that left the trustees with little power to take actions when solvency issues arose. Furthermore, trustees were not held accountable because there was no real avenue for bondholders to examine the performance of trustees or to seek redress for negligence in the performance of their duties.[25]

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21 In 2014, the FMA filed civil proceedings against Price and Partners Trustee Company Ltd (the bond trustee for the failed finance company Viaduct Capital Ltd), using its powers under s 34 of the FMA Act.

22 Mr Hotchin was a director of the failed finance company Hanover Finance Ltd. After having settled with the FMA, he brought proceedings against the two trustees – Perpetual Trust Ltd [Perpetual Trust] and the New Zealand Guardian Trust Co Ltd [Guardian Trust]. In March 2016, the Supreme Court held (by 3:2) that his claim against Guardian Trust (he and Perpetual Trust having settled) could continue: *Hotchin v New Zealand Guardian Trust Co Ltd* [2016] NZSC 24.

23 See the text to nn 59–69 for discussion of the duties owed by the bond trustee to the issuer.

24 Commerce Committee 2007/08 *Financial Review of the Ministry of Economic Development* Appendix B (2009) <www.parliament.nz>. This report's criticism of bond trustee performance is in stark contrast to the predominantly favourable comments made by a 2006 government paper. See Ministry of Economic Development *Review of Financial Products and Providers: Supervision of Issuers* (September 2006) at 39–40.

25 For a discussion of the weaknesses of bond covenants offered by finance companies, see Noel Yahanpath and Szekee Koh "Strength of Bond Covenants and Bond Assessment Framework" (May 2012) Social Science Research Network <www.ssrn.com>; Noel Yahanpath and Sarbjit Singh "Creative Drafting of Bond Covenants: A New Zealand Case" (paper presented to the 16th New Zealand Finance Colloquium, Auckland, 22 May 2013).

4.3 The new bond trust regime

The first legislative response to the finance company collapse has been a mandatory licensing requirement. Under the Securities Trustees and Statutory Supervisors Act 2011 (NZ),[26] trust companies must first obtain a licence before they can be appointed to act as trustees for publicly issued bonds.[27] In 2011, the Commerce Committee made further recommendations for statutory reform, including strengthening the trustee duties, imposing stringent restrictions on exemptions and indemnities, and increasing the remedies available to investors and the regulator.[28] It was also recommended that the term "trustee" be replaced with the more appropriate term "supervisor", because the term trustee "suggests that an investor's funds are being held in trust for them, which could give less sophisticated investors a false sense of security".[29] These proposals are adopted in the FMC Act.

The key provisions for bond supervisors are contained in pt 4 of the FMC Act.[30] While ss 112 and 113 set out the duties of bond supervisors, they need to be read in conjunction with

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26 Now renamed as Financial Supervisors Act 2011 [the Financial Supervisors Act] by s 111(1)(a) of the Financial Markets (Repeals and Amendment) Act 2013.

27 Prior to the Financial Supervisors Act, a bond trustee must either be a trustee corporation or a person approved for the purpose by the Securities Commission. There were effectively five trustee companies acting as a bond trustee in the New Zealand market. After the enactment of the Financial Supervisors Act, six trustee companies have obtained a licence.

28 Commerce Committee, above n 18, at 27 and 35–36.

29 At 27. However, the term "trustee" is still used in the Non-bank Deposit Takers Act 2013 [the NBDT Act].

30 Under the FMC Act, the term "supervisor" is used both in the context of bonds and also for managed investment funds. To distinguish between the two, supervisors for bonds regulated by the FMC Act will be referred to as a "bond supervisor" in this chapter. With regard to bonds issued prior to the FMC Act, or issued in other countries, the term "bond trustee" will continue to be used.

s 111.[31] Both ss 112 and 113 are "civil liability provisions",[32] the breach of which may lead to compensation orders or other civil liability orders being made against the bond supervisor.[33] In contrast, s 111 is not a civil liability provision, and can only be indirectly enforced through ss 112 or 113.

Section 112 states:

> 112 General duties applying in exercise of supervisor's functions
>
> (1) The supervisor of a debt security must—
>
> (a) act honestly in acting as a supervisor; and
>
> (b) in exercising its powers and performing its duties as a supervisor, act in the best interests of the holders of the debt security; and
>
> (c) exercise reasonable diligence in carrying out its functions as a supervisor.
>
> (2) The supervisor of a debt security must also—
>
> (a) do all the things it has the power to do to cause any contravention referred to in section 111(1)(a)(iii) to be remedied (unless it is satisfied that the contravention will not have a material adverse effect on holders of the debt security); and
>
> (b) act in accordance with any direction given by a special resolution of the holders of the debt security that is not inconsistent with any enactment, rule of law, or the trust deed in relation to—
>
> (i) seeking a remedy to a contravention referred to in section 111(1)(a)(iii); and

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31 In addition to the requirements of ss 111–113, bond supervisors are subject to a number of reporting duties, such as the duty to report contravention or possible contravention to the FMA (s 203) and the duty to report serious financial problems of the issuer to the FMA (s 204). Where the issuer is a non-bank deposit taker, the bond supervisor also has reporting duties under the NBDT Act.

32 FMC Act, ss 138 and 485.

33 FMC Act, ss 494 and 497.

(ii) any other matter connected with the supervisor's functions.

(3) The supervisor is not liable for anything done, or omitted to be done, in good faith in giving effect to a direction to it by holders of the debt security.

(4) The duty in subsection (2)(b) is subject to any order of the court made under section 210.

Section 113 imposes a professional standard of care on bond supervisors.

113 Duty of supervisor to comply with professional standard of care

The supervisor of a debt security must, in exercising its powers and performing its duties as a supervisor, exercise the care, diligence, and skill that a prudent person engaged in the business of acting as a licensed supervisor would exercise in the same circumstances.

The bond supervisor's functions are set out in s 111.

111 Functions of supervisor

(1) The supervisor of a debt security is responsible for the following functions:

(a) acting on behalf of the holders of the debt security in relation to—

(i) the issuer of the debt security; and

(ii) any matter connected with the trust deed for the debt security or the terms of the regulated offer; and

(iii) any contravention or alleged contravention of the issuer obligations;[34]

[34] In the exposure draft of the Financial Markets Conduct Bill released in August 2011, s 97(1)(a) (the predecessor of s 111(1)(a)) contained para (iv) which required the bond supervisor to act on behalf of the bondholders in relation to "any contravention or alleged contravention of this Act by *any other person* in connection with the debt security, the trust deed, or the terms of the regulated offer". This provision was deleted in later drafts because bond supervisors "generally have no contractual relationship with these other parties and therefore no effective mechanism through which to discharge this obligation": Ministry of Economic Development *Financial Markets Conduct Bill Exposure Draft – Table of Submissions and Ministry Comments* (October 2011) at 154–155.

and

(b) supervising the issuer's performance—

(i) of its issuer obligations; and

(ii) in order to ascertain whether the assets of the issuer and of each guarantor that are or may be available, whether by way of security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due; and

(c) performing or exercising any other functions, duties, and powers conferred or imposed on the supervisor by or under this Act, the Financial Markets Supervisors Act 2011, or the governing document.

(2) The supervisor must not delegate any of its functions under subsection (1) (except as expressly permitted by this Act or as permitted by, and then subject to, conditions imposed under the Financial Markets Supervisors Act 2011).

The bond supervisor's powers under the FMC Act remain largely unchanged from the previous provisions of the Securities Regulations 2009. Such powers include the power to engage experts,[35] to request the issuer to call a bondholders' meeting,[36] to seek a court order to remedy problems[37] or to allow the bond supervisor not to comply with a special resolution of bondholders.[38] The bond supervisor also has the power to agree to an amendment to the trust deed without the consent of bondholders, provided that the bond supervisor is satisfied that the amendment does not have a material adverse effect on the bondholders.[39] Furthermore, s 115

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35 Section 119.

36 Section 120.

37 Section 208.

38 Section 210. This is a new power. There was no equivalent provision under the Securities Act.

39 Section 108.

gives the bond supervisor an implicit power to require the issuer to provide documents, records, reports or any other relevant information.[40]

Before the new regime under the FMC Act is considered more closely, a general observation should be made. The duties imposed on bond supervisors under the FMC Act are statutory in nature, whereas the duties under the Securities Act were contractual.[41] Under the Financial Markets Conduct Regulations 2014, certain provisions are deemed to be implied into all bond trust deeds. However, these provisions impose duties on the issuer and, indirectly, on the auditors, not on the bond supervisor.

4.4 A closer examination of the bond trust regime in New Zealand

The bond trustee regime under New Zealand law is significantly different from that under English law or United States law.[42] Under English law, the monitoring role of the bond trustee is very limited: it has no duty to investigate whether the bond issuer is in breach of any term of the deed unless it becomes aware of a breach.[43] In addition, trust deeds for bonds issued on the London market often contain a provision which expressly excludes any duty to monitor.[44] The

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40 Section 115 provides that the issuer must provide such documents or information required by the bond supervisor.

41 See above n 16.

42 London and New York are the biggest bond markets in the world. Most bonds issued in the London or New York markets are governed by either English law or New York law.

43 Under English law, bond trustees are to discharge "a custodian rather than an interventionist function": Robert Burgess *Corporate Finance Law* (Sweet & Maxwell, London, 1985) at 104. While a bond trustee might be in breach of trust if it fails to examine the received information with due care, it has no duty to actively seek information to identify whether the bond issuer is in breach. See Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 238–239; Philip Rawlings "The Changing Role of the Trustee in International Bond Issues" [2007] JBL 43 at 57; Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at 223; Louise Gullifer and Jennifer Payne *Corporate Finance Law: Principles and Policy* (Hart Publishing, London, 2011) at 344.

44 Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 25.

position under United States law is similar: prior to the occurrence of an event of default, the role of an indenture trustee (the United States term for bond trustee) is passive and administrative in nature.[45]

In New Zealand, it is generally accepted that the monitoring duties are necessary to protect the interests of bond investors.[46] Similarly to the previous regime, the FMC Act requires bond supervisors to monitor the performance of the issuer's obligations. Furthermore, in cases decided under the Securities Act, the courts have indicated that bond trustees may owe tortious duties to current bondholders, to prospective investors and even to the bond issuers. The monitoring duties, the conduct standards required of bond supervisors, and the issues of indemnity and causation, are discussed below.

4.4.1 Monitoring duties

Section 111(1)(b) of the FMC Act

While the two monitoring duties under the Securities Act have been carried forward into the FMC Act, the precise wording has been revised. Under the Securities Act, the first monitoring duty was to "exercise reasonable diligence to ascertain whether or not any breach of the terms of the deed or of the terms of the offer of the debt securities has occurred".[47] In

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45 Trust Indenture Act of 1939 (US), s 315(a) [the TIA]. The limited and ministerial role of indenture trustees has been confirmed in a long line of cases. See for example *Elliott Associates v J Henry Schroder Bank & Trust Co* 838 F 2d 66 (2nd Cir 1988); *Harris Trust and Savings Bank v E-II Holdings, Inc* 926 F 2d 636 (7th Cir 1991); *Peak Partners, LP v Republic Bank* 191 Fed Appx 118 (3rd Cir 2006); *AG Capital Funding Partners, LP v State Street Bank & Trust Co* 896 NE 2d 61 (NY District Ct App 2008); *Racepoint Partners, LLC v JP Morgan Chase Bank, NA* 928 NE 2d 396 (NY District Ct App 2010). For discussion, see William A Johnson "Default Administration of Corporate Trust Indentures: The General Nature of the Trustee's Responsibility and Events of Default" (1970) 15 St Louis ULJ 203; Steven L Schwarcz and Gregory M Sergi "Bond Defaults and the Dilemma of the Indenture Trustee" (2008) 59 Ala L Rev 1037. For criticism of the TIA regime, see Efrat Lev, above n 7.

46 See [4.5.1] of this thesis.

47 Securities Regulations 2009, sch 15, cl 1(1)(a).

contrast, s 111(1)(b)(i) of the FMC Act provides that the bond supervisor is obliged to "supervise the issuer's performance of its issuer obligations".

"Issuer obligations" include the obligations of the issuer under the bond trust deed, the terms of the offer of the bonds, the obligations under the FMC Act and, if the issuer is a non-bank deposit taker, the Non-bank Deposit Takers Act 2013 (NZ).[48] It is uncertain whether the "issuer obligations" include disclosure obligations, such as its obligation not to offer bonds if any statement in the relevant Product Disclosure Document is misleading.[49] If the disclosure obligations are included, it would mark a radical change from the previous regime where the issuer, not the bond trustee, was responsible for the accuracy of the contents of the prospectus.[50] One would expect that, if this was indeed the drafter's intention, it would need to be explicitly expressed.

Under the Securities Act, the second monitoring duty was to "exercise reasonable diligence to ascertain whether or not the assets of the borrowing group that are or may be available, whether by way of security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due".[51] Its corresponding provision under the FMC Act is s 111(1)(b)(ii) which, read together with the opening sentence of s 111(1)(b), requires the bond supervisor to supervise "the issuer's performance in order to ascertain whether the assets of the issuer and of each guarantor that are or may be available, whether by way of security or otherwise, are sufficient or likely to be sufficient to discharge the amounts of the debt securities as they become due". Arguably, the word "performance" in

48 FMC Act, s 6.

49 FMC Act, s 82.

50 In *Financial Markets Authority v Hotchin* [2013] NZHC 1611 at [49] [*Hotchin*], Winkelmann J held that there was no tenable argument that the trustees owed prospective or roll-over investors a duty of care in respect of the accuracy of the prospectus. This finding was not appealed.

51 Securities Regulations 2009, sch 15, cl 1(2).

this context includes all aspects of the issuer's operation, such as the performance of its contractual obligations with its key trade partners, as long as monitoring such performance is relevant to the purpose of assessing the adequacy of the issuer's assets.

Concurrent duties in tort

Every so often, the issue of concurrent tortious duties comes up in litigation. Whether or not a tortious duty exists is relevant to several issues, such as the measure of damage, contributory negligence, and contribution claims. In *Fletcher v National Mutual Life Nominees Ltd*, the Court held that there were no concurrent tortious duties owed by a bond trustee to the bondholders.[52] Since then, however, the New Zealand courts have indicated in a series of preliminary cases that the bond trustee might also owe concurrent duties in tort.[53]

There are strong objections in principle to a concurrent liability in tort as between contracting parties. As Lord Scarman succinctly articulated in *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd*, "[t]heir Lordships do not believe that there is anything to the advantage of the law's development in searching for a liability in tort where the parties are in a contractual relationship. This is particularly so in a commercial relationship."[54] In the context of bonds, concurrent tortious duties are particularly undesirable. Bonds are transferable securities, traded on local and global capital markets. The price of a bond is determined by the legal rights of the

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52 *Fletcher v National Mutual Life Nominees Ltd*, above n 6, at 103–105.

53 In *Porter v New Zealand Guardian Trust Co Ltd* (1996) 7 TCLR 323 (HC) at 329, the Court held that a duty of care was arguable. In *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 664 (CA) at 684, Gault J said in obiter that the monitoring duties were enforceable in equity and "[t]here is doubtless the same duty in tort". See also *Hotchin*, above n 50, at [37].

54 *Tai Hing Cotton Mill Ltd v Liu Chong Hing Bank Ltd* [1987] HKLR 1041 (PC) at 1052. Since then both the English courts and the New Zealand courts have held that concurrent duties may exist both in tort and in contract. See for example *Henderson v Merrett Syndicates Ltd* [1995] 2 AC 145 (HL); *Riddell v Porteous* [1999] 1 NZLR 1 (CA). For recent discussion and criticism of concurrent liabilities, see Rupert Jackson LJ "Concurrent Liability: Where Have Things Gone Wrong?" (paper presented to the Society of Construction Law and the Technology & Construction Bar Association, 30 October 2014).

bondholders, together with economic and commercial factors. The legal rights of a bondholder should be determined only by the terms of the trust deed and, where applicable, the statutes. Imposing a tortious duty outside the parameters of the trust deed terms and the statutes will bring elements of uncertainty into the bond pricing equation.

Under the new bond trust regime, the case against imposing concurrent tortious duties is even stronger. After extensive consultation with a wide range of stakeholders, the FMC Act now specifies the rights and duties of the issuer, the bond supervisor and the bondholders. Courts are therefore left with less reason and room to impose tortious duties outside the statutory regime.

Duties owed to prospective investors

The issue of whether a bond trustee owes duties to prospective investors was discussed in *Purdue v Perpetual Trust Ltd*.[55] Perpetual Trust Ltd (Perpetual Trust) was the bond trustee of Burbery Finance Ltd (Burbery). On 17 June 1988, Burbery's auditors advised Perpetual Trust that Burbery was in breach of the terms of the trust deed. In a prospectus issued later in June 1988, Perpetual Trust made a statement to the effect that a technical breach had occurred, but Perpetual Trust was satisfied with the steps taken by Burbery to rectify the position. The plaintiffs deposited funds with Burbery between 1 July 1988 and 10 August 1988. Burbery was placed into receivership on 10 August 1988.

One of the claims of the plaintiffs was that Perpetual Trust breached its duty of care in tort. Specifically, it was alleged that Perpetual Trust should have taken positive steps to prevent Burbery from accepting new deposits. Had the duty not been breached, the plaintiffs would not have invested in the deposits, and would not have suffered the loss. Perpetual Trust sought to

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55 *Purdue v Perpetual Trust Ltd* HC Christchurch CP85/94, 5 April 2001.

strike out the claims. The Court refused to strike out, holding that, given the breadth of the duty imposed on bond trustees under the Securities Act, a duty of care was at least arguable.[56]

The position of prospective investors under the FMC Act is not clear. First, in terms of whether bond supervisors owe statutory duties to prospective investors, s 494 provides that *any person* may apply to the court for a compensation order if the bond supervisor has breached its duties, and *the person* has suffered loss or damage because of the contravention. Clearly, some restrictions must be read into this section – it should not cover persons such as trade creditors or equity investors, because such an interpretation would erode the protection intended for bond investors under the FMC Act.[57] However, it appears that prospective investors might be able to sue under s 494 as arguably, they are the type of investors whom the bond trust regime under the FMC Act aims to protect. Second, as to whether bond supervisors owe prospective investors the duty of care in tort, this proposition is at least arguable on the basis of the previous case law.

It should be pointed out, however, that holding bond supervisors liable to prospective investors may put the bond supervisor in a decisional dilemma in situations where the interests of prospective investors may conflict with the interests of existing bondholders. For example, consider a situation where an issuer has issued certain bonds which are about to mature. The issuer is in breach of a financial covenant in the trust deed, and its financial position may deteriorate further. The issuer decides to issue new bonds, the proceeds of which will be used to repay the existing bonds when they mature. If the bond supervisor needs only to consider the interests of the existing bondholders, then it may decide not to trigger an event of default and

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56 At [31]. See also *Hotchin*, above n 50, at [41]–[48].

57 Under s 42 of the Financial Markets Supervisors Act 2011, only a product holder or a resident of a retirement village can seek compensation orders. How this section is to be reconciled with s 494 of the FMC Act is unclear.

allow the issue of the new bonds to proceed.[58] In contrast, if the bond supervisor must also take into account the interests of prospective investors, it may choose to trigger an event of default, effectively preventing the issuer from issuing new bonds and placing the issuer in liquidation. In such a case, the interests of the prospective investors are protected, but at the expense of reducing the likelihood of a full repayment to the current bondholders.

A further reason for not extending the benefits of the monitoring duties to prospective investors is that, on a policy level, prospective investors should be protected by the disclosure regime and, once the bonds are issued, by the monitoring duties imposed on the bond supervisor appointed for the *new bonds*.

Duties owed to the issuer

National Finance 2000 Ltd (in rec and in liq) v William Buck New Zealand Ltd involved a contribution claim made by the auditors of a bond issuer against the bond trustee.[59] The novelty of this contribution claim was that it was based on alleged breach of duties owed by the bond trustee to the *issuer*.[60]

Under a trust deed between National Finance 2000 Ltd (National Finance) and Covenant Trustee Company Ltd (Covenant Trustee), National Finance issued debt securities to the public. The trust deed contained a number of financial covenants, such as the permissible percentages of the total value of related party transactions and the total liabilities in relation to the total

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58 Of course, the issuer will need to fully disclose the breach of the covenant to the new investors. It is then up to the new investors to decide whether to invest or not.

59 *National Finance 2000 Ltd (in rec and in liq) v William Buck New Zealand Ltd* HC Auckland CIV–2010–404–7157, 7 December 2011.

60 In 2014, the liquidator of Capital and Merchant Finance Ltd initiated proceedings against Perpetual Trust, alleging breach of contract and negligence. See *Capital + Merchant Finance Ltd v Perpetual Trust Ltd* [2015] NZHC 1233; Hamish Fletcher "Perpetual Trust lawsuit back on track" *The New Zealand Herald* (online ed, Auckland, 7 September 2015).

tangible asset value. When National Finance failed, the receivers brought proceedings against the issuer's auditors in both contract and tort, on the grounds that the auditors failed to detect and report breaches of such covenants. The auditors issued a third party claim against Covenant Trustee, seeking contribution under s 17 of the Law Reform Act 1936 (NZ). Covenant Trustee applied to strike out the claim.

Since s 17 is applicable to tortfeasors only, the auditors claimed that Covenant Trustee owed National Finance duties in tort. In addition, Associate Judge Bell was of the view that it was arguable that equitable contribution might be available to concurrent wrongdoers when there was coordinate liability to make good a single loss, even though the claims were under different heads of obligations.[61] Therefore, the discussion of whether Covenant Trustee owed a duty to National Finance was not confined to tort law.

In terms of the monitoring duties under the Securities Act, the Act was silent as to whom the duties to monitor were owed. The Associate Judge found that the issuer was not within the class of people contemplated by Parliament as entitled to enforce the monitoring duties; hence, the cause of action for breach of statutory duty was not available to National Finance.

The Associate Judge then turned to the issue of whether the trustee owed the issuer a contractual duty to monitor, ultimately holding that such a contractual duty did indeed exist. This is because the trustee fee was paid by the issuer, hence the issuer had an interest in seeing that the services it paid for were carried out.[62]

Lastly, the Associate Judge looked at the issue of a duty of care in tort. Applying the two-stage test for determining a duty of care at common law as set out by Glazebrook J in *Rolls-Royce New Zealand Ltd v Carter Holt Harvey Ltd*,[63] the Associate Judge held that the

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61 *National Finance 2000 Ltd (in rec and in liq) v William Buck New Zealand Ltd*, above n 59, at [36].

62 At [46]–[48].

63 *Rolls-Royce New Zealand Ltd v Carter Holt Harvey Ltd* [2005] 1 NZLR 324 (CA) at [58].

contractual relationship between the trustee and the issuer gave rise to the required proximity, and the imposition of a duty of care was supported by wider policy reasons, including enhancement of trustee accountability.[64]

Three comments may be made on this judgment.[65] First, the finding that monitoring duties under the Securities Act were not owed to the issuers is undoubtedly correct. This should also be the position under the FMC Act. Similarly to the Securities Act, the FMC Act does not state to whom the duties of the bond supervisor are owed. However, there is little doubt that the FMC Act is meant to offer protection to investors, rather than to issuers.

Second, with due respect, the conclusion that bond trustees may arguably owe a contractual monitoring duty *to the issuer* is difficult to justify. The provisions of the monitoring duties as implied into bond trust deeds under the Securities Act did not state to whom the duties were owed. As a general rule, interpretation of unclear or incomplete contractual provisions "must turn on the meaning that reasonable persons in the positions of the parties would have attached if they had given the matter thought".[66] In other words, what would the issuer and the trustee, acting reasonably, have agreed to if they were specifically asked the question of whether the monitoring duties were owed to the issuer? While not completely free from doubt, the answer would most likely to be a "no".[67] The interests of the bondholders can be, and often are, in direct conflict to the interests of the bond issuer. The bond trustee is appointed to act for

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64 *National Finance 2000 Ltd (in rec and in liq) v William Buck New Zealand Ltd*, above n 59, at [61]–[66]. The case did not go to trial, as the parties settled.

65 For further comments on this case, see Rachel Paris "Trustee Limitation of Liability Clauses in Commercial Transactions: Issues and Observations from a New Zealand Perspective" (paper presented to the Banking & Financial Services Law Association Conference 2014, Queenstown, 2 August 2014) at 5–7.

66 E Allan Farnsworth *Farnsworth on Contracts* (3rd ed, Aspen Publishers, New York, 2004) § 7.9 at 285.

67 The question of to whom a duty is owed often arises in multilateral contracts. To address this issue, such contracts usually contain express provisions to clarify that certain duties are owed to a particular contracting party only and cannot be enforced by other parties.

the benefit of the bondholders, not the issuer. Having duties owed to both the bondholders and the issuer could make performing the task of protecting the interests of bondholders near impossible. The mere fact that the issuer pays the trustee's fees is not a very significant factor.

Third, the argument that the bond trustee could owe the bond issuer a duty of care in tort is untenable. One policy reason relied upon by the Associate Judge is that, by allowing the bond issuer to bring claims against the bond trustee, the funds recovered by the issuer (or the receiver in this case) could be used to pay investors to compensate their losses.[68] However, any funds paid by the bond trustee to the issuer will be distributed pro rata among all creditors of the issuer, not just the bondholders. Evidently, this result would be contrary to the purpose of the bond trust regime – providing protection to the bondholders, not to all the creditors. In this regard, it should be mentioned that, in *Concord Trust v Law Debenture Trust*, Lord Scott said that "it [is] very difficult to understand how it could be arguable that the Trustee owed a tortious duty of care [to the issuer]".[69]

Limiting the monitoring duties

In practice, bond supervisors almost always insert various protective clauses into the bond trust deeds to limit the scope of their monitoring role or their potential liabilities.[70] For example, the bond trust deed may specify that the bond supervisor is entitled to assume that no breach of bond trust terms has occurred until it has received notice to the contrary from the bond issuer or a bondholder. Another example of protective clauses is where the bond

68 *National Finance 2000 Ltd (in rec and in liq) v William Buck New Zealand Ltd*, above n 59, at [68].

69 *Concord Trust v Law Debenture Trust Corp plc* [2005] UKHL 27 at [38].

70 For general discussion of trustees' limitation of liability, see Diccon Loxton and Nuncio D'Angelo "Trustees' Limitation of Liability: Myths, Mysteries and a Model Clause" (2013) 41 ABLR 142.

supervisor has an absolute discretion to determine whether a breach of the terms of the trust deed has occurred.[71]

Under the previous regime, the legal effect of protective clauses was dealt with under s 62 of the Securities Act. Section 62 provided that "any provisions of a deed or contract relating to debt securities … shall be void in so far as it would have the effect of exempting a trustee … thereof from or indemnifying him or her against liability for breach of trust where he or she fails to show the degree of care and diligence required of him or her as trustee … *having regard to the provisions of any deed conferring on him or her any powers, authorities, or discretions*" (emphasis added).

Section 750 of the Companies Act 2006 (UK) is the English law equivalent of s 62. The common view is that protective clauses are valid because of the last limb of subs (1) – "having regard to the provisions of any deed conferring on him or her any powers, authorities or discretions".[72] However, as pointed out earlier, English law does not impose monitoring duties on bond trustees.[73] In contrast, the Securities Act did impose monitoring duties. Therefore, compared to the English law position, the last limb of s 62 might offer less protection to bond trustees than its equivalent under English law.

Section 62 was not directly carried forward into the FMC Act. In this regard, s 107 of the FMA Act provides that any term in a trust deed has no effect if it contravenes the FMC Act.

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71 In terms of financial covenants, due to the complexity of such provisions and the issuer's creative drafting, it can be difficult to determine whether a breach had indeed occurred. See Yahanpath and Singh, above n 25.

72 Tennekoon, above n 43, at 238; Fuller, above n 43, at 223; Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 4.

73 See above n 43.

Section 107 does not contain an equivalent of the last limb of s 62. Thus, it is now more likely that protective clauses offer little, if any, protection to bond supervisors.[74]

Are monitoring duties effective?

The monitoring duties are the most distinctive feature and the cornerstone of the New Zealand bond trust regime. It is submitted, however, that they are unlikely to achieve their intended purposes of protecting investors. There are a number of reasons for this proposition.[75]

First, discharging the monitoring duties requires the bond supervisor to analyse a wide range of complex economic and financial information. Due to a lack of resources and expertise, it may well prove difficult for bond trustees to conduct such analyses.[76] This can be illustrated by a simple (and somewhat simplistic) example. Assuming that a bond issuer is in the business of lending money on floating interest rates to property developers and the market interest rate has just gone up, how should the bond supervisor interpret this market event and take monitoring actions accordingly? On the one hand, a higher market interest rate means that the bond issuer's profits will increase because the property developers will have to pay higher interest payments to the bond issuer. Therefore, there will be a lower likelihood of the bond issuer defaulting under the bonds. On the other hand, a high interest rate could lead to lower property prices, potentially increasing the risk of the loans defaulting, which would increase the default risk of the bond issuer.

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74 Post the FMC Act coming into force, protective clauses still appear in some trust deeds.

75 For criticism of the Australian legislative proposals to broaden the trustee's role to monitor the financial position, see Eve Brown "From 'If Not, Why Not' to 'If Not, NOT' – Regulatory Reform of the Debenture Sector" (2014) 32 C&SLJ 159 at 168–170.

76 A recent empirical study found that investors deem "investment bank trustees" (ie bond trustees who also act as underwriters) as more effective monitoring devices than other trustee companies who only perform the trustee role: Christian Andres, Andre Betzer and Peter Limbach "Delegated Monitoring: the Effectiveness and Pricing of Bond Indenture Trustees" (February 2012) University of Münster <www.uni-muenster.de>.

In this regard, it might be useful to compare trustee companies with rating agencies, as rating agencies also routinely conduct similar analyses to determine the bond default risk, and assign or change bonds' ratings accordingly. Compared to trustee companies, rating agencies have far more resources and expertise at their disposal, and operate on a much bigger scale. Rating services in the New Zealand bond markets are dominated by the three largest credit rating agencies in the world – Standard & Poor's (S&P), Moody's Investors' Service and Fitch Ratings. In 2015, S&P's total revenue was over USD 5 billion,[77] whereas the total revenue of The New Zealand Guardian Trust Ltd (Guardian Trust) was NZD 44 million.[78] Furthermore, rating agencies charge much higher fees for their services,[79] and are able to exclude their liabilities to investors for negligence,[80] something bond supervisors are not allowed to do.[81] Short of a total transformation of the current corporate trustee sector and a spike in trustee fees, full compliance with the monitoring duties is likely to be challenging for trustee companies operating in New Zealand bond markets.[82]

Second, for a bond supervisor to perform its monitoring duties, it needs to receive the financial and business information from the bond issuer on a constant or even continuous basis.

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77 McGraw Hill Financial *2015 Annual Report*.

78 Based on its 2015 financial statement filed with the Companies Office.

79 Rating agencies typically charge around 0.5 per cent of the issue size. For a $50 million bond issue, the rating fee will be around $250,000. In contrast, based on anecdotal evidence, the fee charged by a bond supervisor in New Zealand is around $30,000, irrespective of the issue size.

80 However, after the Global Financial Crisis, the pressure on rating agencies is growing. For example, in Europe, art 35a(5) of Regulation (EC) No 1060/2009 (as inserted by Regulation (EU) No 462/2013 [2013] OJ L146/1) now prohibits any clause excluding or limiting the rating agency's liability for intentional breach or gross negligence.

81 FMC Act, s 107.

82 According to a report produced by the FMA based on its on-site reviews of bond trustees and fund trustees (FMA *Securities Trustees and Statutory Supervisors – Feedback from Monitoring Visits* (April 2014) <www.fma.govt.nz>), the licensees' processes for analysing information and data could be improved, and there were a number of areas where some licensees "lacked appropriate professional skepticism" (at 9).

However, the bond supervisor is a legal entity separate from the issuer. It is not involved in the issuer's day-to-day business operations. Therefore, "the trustee cannot, without subjecting itself to too great a hardship, investigate into all the affairs of the company in order to learn of every breach".[83] For example, it is not clear what information the bond supervisor should request from the issuer, and how often it should do so.[84] In 2013, the FMA issued a guidance note for supervisors, setting out its expectations of how supervisors should carry out their functions.[85] In the FMA's view, it is not acceptable for supervisors to simply "receive regular reports and to react when an issue becomes manifest".[86] Instead, they should have an in-depth understanding of the issuer's sector and business, conduct independent checking and analysis, and adopt a risk-based and proactive monitoring plan.[87] Yet, useful as it is, the guidance note still falls short of the concrete advice bond supervisors need in order to discharge their monitoring duties.

Finally, even assuming a bond supervisor does receive timely information from the bond issuer, the duties to monitor are likely to be effective only in limited situations. This is because the effectiveness of the monitoring duties depends on the quality of the information received from the issuer. If the directors and senior executives of the issuer are fraudulent, deliberately providing false or misleading information to the bond supervisor, it will be difficult or impossible for the bond supervisor to make a proper determination as to whether a breach of the bond trust terms has occurred, or whether the assets of the issuer are sufficient to discharge the bonds. If the directors and senior executives are acting honestly and diligently, they are likely to be the first ones to identify potential breaches or serious financial problems, and to

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83 Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) 42 Harv L Rev 198 at 245.

84 Ministry of Economic Development, above n 34, at 154.

85 FMA *Guidance Note: Monitoring by Securities Trustees and Statutory Supervisors* (June 2013).

86 At 6.

87 At 11.

take remedial actions accordingly. The bond supervisor's monitoring role will be superfluous in such situations.

The only situation in which a bond supervisor might add value to the investors is where (a) the directors and senior executives are acting honestly but negligently, such as failing to identify a breach of the terms of the trust deed; and (b) the bond supervisor, relying on the same information available to both the issuer and the bond supervisor, is supposedly able to identify the problems. Arguably, if the directors or the senior executives who actually run the company cannot determine the problems, it seems less likely that the bond supervisor, an external party, will be able to do so.[88]

In conclusion, as a result of recent securities law reform and case law developments, the monitoring duties of bond supervisors have been strengthened and expanded. However, the monitoring duties are too onerous and are therefore unlikely to achieve their purposes.

4.4.2 Conduct standards

While the monitoring duties are onerous, they are not strict liability duties. For example, failing to identify a breach of the issuer's obligation does not necessarily mean that the bond supervisor is liable. It will be liable only if it fails to comply with the required conduct standard.

Previously, the conduct standard applicable to the monitoring duties was the "reasonable diligence standard".[89] Under the FMC Act, the reasonable diligence standard has been

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[88] In the business world, an external party does not normally take on a contractual monitoring role. Nor does the law usually impose one. It has been suggested that non-executive directors have a duty to actively monitor management's decision-making. See for example Rita Esen "Managing and Monitoring: the Dual Role of Non-executive Directors on UK and US Boards" (2000) 11(6) ICCLR 202. This monitoring duty can be justified on the basis of the directors' ready access to information and the close relationship between the monitor (the directors) and the person being monitored (the managers). This is not the case with a bond supervisor.

[89] Securities Regulations 2009, sch 15, cl 1.

extended to all functions of a supervisor.[90] In addition, s 113 imposes an additional conduct standard, requiring the bond supervisor to exercise "the care, diligence, and skill that a prudent person engaged in the business of acting as a licensed supervisor would exercise in the same circumstances" (hereafter the "prudent supervisor standard").

An immediate question is why two conduct standards, rather than one, are required of the bond supervisor. It is unusual to have two statutory conduct standards applicable to the same person in respect of the same conduct. In theory, two conduct standards are necessary only if there are some differences between the two. However, if one standard is higher than the other, then it would be unnecessary to have the other standard, because any breach of the higher standard will inevitably lead to the lower standard also being breached. In fact, it is strongly arguable that the reasonable diligence standard and the prudent supervisor standard are effectively identical: if a bond supervisor has exercised reasonable diligence, it is hard to see how it could fail the prudent supervisor standard; conversely, if a bond supervisor acts in the same way as a prudent supervisor would do in the same situation, it is hard to see how it could breach the reasonable diligence standard. The fact that the FMC Act now contains two conduct standards is likely due to the need to carry forward the previous reasonable diligence standard under the Securities Act, and to import the prudent person standard under s 13C of the Trustee Act 1956 (NZ) into the FMC Act.[91] If amendments are to be made to the FMC Act in the future, it might be desirable to combine the two conduct standards into one.

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[90] Section 112(1)(c).

[91] Section 13C of the Trustee Act 1956 (NZ) provides that "[a] trustee, in exercising any power of investment, shall exercise the care, diligence, and skill that a prudent person engaged in that…business would exercise in managing the affairs of others".

Generally speaking, whether a conduct standard is complied with is largely a question of fact.[92] The leading case on the reasonable diligence standard is *Pakuranga Park Village Trust v Fenton* (*Pakuranga Park Village*).[93] The plaintiffs in this case were residents of the Pakuranga Park Retirement Village (the Village) operated by a trading trust on land of Villages of New Zealand (Pakuranga) Ltd (the Company). Each resident made a deposit with the Company and received a "licence to occupy" in return. The deposits constituted debt securities. Guardian Trust was appointed as the trustee under a debenture trust deed for the deposits.[94] The Company granted Guardian Trust a charge over the land to secure its obligations to repay the deposits. The Company's land included a bowling green area. It proposed to sell this area and relocate the bowling green. The residents claimed that this was a breach of the licence to occupy and also a breach of the terms of the debenture trust deed.[95] However, Guardian Trust took the view that selling the area was not a breach of the licence, and consented to the sale by releasing the charge of that part of land on the basis that, in its view, the interests of the depositors would not be materially prejudiced by such release.[96]

The Court was confronted with the issue of whether Guardian Trust complied with its duty to exercise reasonable diligence to ascertain whether a breach of the licence to occupy had occurred. The Court reviewed the process followed by Guardian Trust (including moving

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92 The reasonable diligence standard has not occupied much court time. This is also the case with the duties of care, diligence and skill imposed on company directors under the Companies Act 1993. See Peter Watts, Neil Campbell and Christopher Hare *Company Law in New Zealand* (LexisNexis, Wellington, 2011) at 550.

93 *Pakuranga Park Village Trust v Fenton* (1998) 3 NZ ConvC 192,681 (CA).

94 Guardian Trust was also the statutory supervisor for the village.

95 Under the debenture trust deed, the Company undertook to comply with the terms of the licence to occupy.

96 Under the debenture trust deed, Guardian Trust had the power to release any part of the charged property from the charge if, in its opinion, the interests of the depositors would not be materially prejudiced: *Pakuranga Park Village Trust v Fenton*, above n 93, at 192,686–192,687.

promptly to seek information from the Village about the sale proposals, reminding the Company several times that it could not sell the land without the trustee's consent, and regularly seeking legal advice) and the assessment made by Guardian Trust of the request for consent. In the end, the Court concluded that Guardian Trust was in compliance with the reasonable diligence standard.[97]

Another issue arose as to what extent the Court could review Guardian Trust's decision to release the charge. It seems that the Court implicitly endorsed Guardian Trust's argument that the Court ought not to interfere with the exercise by Guardian Trust of its discretionary powers unless Guardian Trust had acted on a misconceived understanding of its power or exercised the powers for improper purposes, unreasonably or in bad faith.[98] This is consistent with the orthodox approach under the general trust law.[99]

It should be noted that *Pakuranga Park Village* was decided under the Securities Act regime under which the reasonable diligence standard applied only to the monitoring duties, not to the exercise of trustee powers.[100] In contrast, under the FMC Act, both the reasonable diligence standard and the prudent supervisor standard apply to exercising powers, as well as performing duties. This naturally leads to the question: should the courts continue to adopt the orthodox approach to review a bond supervisor's decision? It is submitted that the orthodox approach should continue to apply.

While trust corporations might not be expert in terms of monitoring the bond issuer's performance, they have more expertise and experience in dealing with bond defaults and other

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97 At 192,694–192,698.

98 At 192,692.

99 For general discussion, see Law Commission *Law of Trusts: Preferred Approach Paper* (NZLC IP31, 2012) at 192–203.

100 While s 13C of the Trustee Act 1956 imposes the prudential person standard, this section applies to the power of investment only.

corporate events, such as restructuring. Very often, bond supervisors need to make difficult decisions in challenging situations, particularly if the issuer is in default. If necessary, they should be able to choose not to take enforcement actions against the issuer, as long as this is in the best interests of the bondholders. In fact, it has been widely recognised that a strict enforcement of bond trust terms "may not be the best approach where the issuer is so fragile that … acceleration might bring the house of cards tumbling down and might not produce much in the way of funds to be shared among the bond-holders, particularly where the bonds are unsecured".[101] If a bond supervisor's decisions could be challenged under a low threshold of unreasonableness based on hindsight, it would discourage bond supervisors from taking reasonable and legitimate risks.[102]

Under the Securities Act, there are potential concerns about the courts adopting the orthodox approach for the review of bond trustees' decisions, as this makes it difficult to hold bond trustees accountable. When a bondholder seeks judicial review of the bond trustee's decision, the burden of proof is on the bondholder – it needs to provide evidence of the procedures adopted, or the factors relied upon, by the bond trustee in making the decision. However, normally, bondholders do not have such information, as the bond trustee is not obliged to disclose such information to bondholders. These concerns no longer exist under the FMC Act, because the FMA can exercise its regulatory powers to require bond supervisors to provide such information to the FMA, and take enforcement actions against bond supervisors on behalf of the bondholders when necessary.

To conclude, while the FMC Act contains the reasonable diligence standard as well as the prudent supervisor standard, there seems to be no real difference between the two. In terms of judicial review of a bond supervisor's decision, there are reasons to expect that the courts

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101 Rawlings, above n 43, at 65; Brown, above n 75, at 161.

102 Schwarcz and Sergi, above n 45, argued that the business judgment rule should apply to indenture trustees.

will not interfere unless the bond supervisor has exceeded its power, or exercised its power for improper purposes, unreasonably, or in bad faith.

4.4.3 Indemnity

Indemnities are allowed under the FMC Act, with two conditions: first, they must be set out in the bond trust deed; second, they are available only in relation to the proper performance of the bond supervisor's duties.[103]

Under a standard bond trust deed, the bond trustee has indemnities against the bond issuer and against the trust assets. In addition, when the bondholders instruct the bond trustee to take certain actions, the bond trustee is entitled to ask the bondholders to provide a satisfactory indemnity before proceeding. In practice, the bondholder indemnity often gives rise to disputes. For example, the bondholders may propose to provide a personal guarantee, but the bond trustee may insist that only an indemnity provided by a reputable bank is acceptable. Another example is where a current bondholder has provided a satisfactory indemnity to the bond trustee and wants to sell the bonds to a potential purchaser. The bond trustee may insist that the potential purchaser provide an indemnity before the sale of bonds takes place.[104]

The leading English case on bondholder indemnity is *Concord Trust v Law Debenture Trust Corp plc*.[105] In this case, the Court was asked to consider the scope of the liability against which a bond trustee may reasonably require to be indemnified. Under the terms of the relevant trust deed, the bondholders were entitled to, and did, appoint a Mr Rymaszewski to the issuer's board. However, the bond issuer suspended him from the board. The bond trustee served a notice of event of default on the bond issuer. In addition, the bondholders requested that the

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103 FMC Act, s 105(1).

104 Saptak Santra "Bondholders, Fight Back" (2010) 29 IFLR 26.

105 *Concord Trust v Law Debenture Trust Corp plc* [2005] UKHL 27.

trustee serve a notice of acceleration.[106] The issuer contended that there had been no event of default and, more importantly, that a notice of acceleration would cause substantial loss to the issuer. The trustee's assessment of such loss was in the region of €1 billion. Therefore, the trustee refused to serve the notice of acceleration unless the holders provided a satisfactory indemnity not only against the costs of potential litigation, but also against the damages which might be claimed by the issuer against the trustee for the loss caused by the acceleration notice. The holders issued proceedings against the bond trustee seeking a declaration that the trustee was obliged to serve a notice of acceleration.

Lord Scott held in favour of the bondholders on the grounds that, even assuming the notice of acceleration was wrongly served, the issuer had no cause of action against the trustee. In particular, Lord Scott observed that a bond trustee "cannot reasonably insist on an indemnity to cover the risk unless the risk is more than a merely fanciful one".[107]

In New Zealand, bondholder indemnities are probably less of an issue in practice. This is because, unlike the investors in international bond markets, the majority of bondholders in New Zealand are retail investors. Retail investors normally do not give instructions to bond trustees to take risky legal actions.

4.4.4 Causation

Causation is one of the most complex issues in law.[108] This is more so in cases involving disputes between bondholders and bond supervisors. The reason is, typically, that the direct cause of the loss suffered by bondholders is the failure of the issuer, which is, in turn, caused

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[106] Once the bonds are accelerated, the principal of the bonds becomes immediately repayable. Usually, this will trigger cross defaults under other bonds and loans of the issuer, with a high probability of pushing the issuer into insolvency.

[107] Above n 105, at [34].

[108] For general discussion, see HLA Hart and Tony Honeré *Causation in the Law* (2nd ed, Oxford University Press, Oxford, 1985).

by internal factors (such as the fraud or negligence of the directors or senior managers) or external factors (such as the default of the issuer's contracting parties or economic downturns). The causal effect of the breach of the bond supervisor is secondary in nature − the bond supervisor should have intervened to prevent the occurrence of the loss.

"Close nexus" versus "distant nexus"

Causation was the key issue in *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* (*BNZ*).[109] This case concerned a breach of the trust deed terms by the security trustee. Commercial Securities Ltd (Comsec) borrowed funds from four banks under a combined funding loan agreement. One of the banks was the Bank of New Zealand (the plaintiff). To secure its obligations under the loans, Comsec issued to the banks the first ranking security stock under a debenture trust deed for a total amount equal to 110 per cent of the loans. Guardian Trust was appointed as trustee under the debenture trust deed. Under cl 7 05(e) of the trust deed, Guardian Trust was required to exercise reasonable diligence to ascertain whether any term of the trust deed was breached. One of the covenants contained in the trust deed was that Comsec was not allowed to lend money to any non-charging subsidiary unless such a loan was secured to the satisfaction of the trustee. Comsec breached this covenant by lending approximately $20 million to its subsidiaries. The lending was disclosed in the financial statements provided by Comsec to Guardian Trust. However, Guardian Trust did not notice this breach. Comsec went into liquidation for reasons unrelated to those loans, as they had all been fully repaid.

The plaintiff brought proceedings against Guardian Trust, claiming that, had the breach been detected, it would have been able to exit the loan earlier on and therefore avoid the loss. Guardian Trust admitted its negligence in failing to ascertain that a breach had occurred and to notify the plaintiff, but denied liability on the basis of causation. In the High Court, Fisher J

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109 *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 213 (HC). See too *BPE Solicitors v Hughes-Holland* [2017] UKSC 21.

gave decision in favour of Guardian Trust. The trial decision was affirmed in the Court of Appeal.[110]

In addressing the issue of causation, Fisher J distinguished between two types of cases. In cases of the first category, a "close nexus" is required. Under this approach, "the causal nexus between breach and loss must be substantial, the kind (although not the extent) of the loss reasonably foreseeable, and the loss sufficiently proximate in other respects heavily influenced by policy".[111] Breach of contract and tortious negligence fall under this category.[112] In terms of the second category, a "distant nexus" would generally constitute sufficient causation. A distant nexus is established by applying a *but for* test. Cases involving breaches of trust causing loss to the trust estate, breach of fiduciary duty and intentional torts belong to the second category.

To address the question of whether there was a loss of the trust property, it is first necessary to determine what constitutes the trust property in this case. While recognising that "some imagination is required to adapt traditional trust principles to a situation in which there were not trust funds or property of the more traditional kind", Fisher J concluded that the trust property of the trust in question consisted of a bundle of interests, rights and powers held by Guardian Trust on the banks' behalf, including the charge over Comsec's property, the right to require Comsec to comply with the covenants in the trust deed, and the right to enforce the security.[113] A diminution in the value of the charged assets would be a loss to the trust estate,

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110 *Bank of New Zealand v New Zealand Guardian Trust Company Ltd* [1999] 1 NZLR 664 (CA). The discussion herein focuses on Fisher J's judgment as it is "more illuminating than the judgments given in the Court of Appeal": Steven Elliott "Remoteness Criteria in Equity" (2002) 65(4) MLR 588 at n 36.

111 *BNZ*, above n 109, at 248.

112 It is possible to argue that, while a normal breach of contract belongs to the "close nexus" category, an intentional breach of contract should belong to the "distant nexus" category to deter intentional wrongdoings.

113 *BNZ*, above n 109, at 250.

and it was clear that when the security was enforced, the value of the charged assets was not sufficient to cover the loan. However, the plaintiff did not allege that Guardian Trust's default contributed to the reduction in the value of the charged assets. This is understandable, given that the unsecured loans made by Comsec to its subsidiaries had been fully repaid. Nor was it alleged that other rights and powers, such as the right to enforce the security, were diminished. "The rights and powers were the same before and after the default."[114]

The loss alleged by the plaintiff was the loss of an early exit opportunity. This loss was "a personal loss suffered outside the trust estate".[115] This is because the right to repayment with interest belonged to the banks only. It was never vested in Guardian Trust, and therefore never formed part of the trust estate.[116] Fisher J then discussed whether Guardian's breach was a breach of fiduciary duty, and concluded that it was not.[117] As such, a close nexus was required in this case. This was not established in this case, because it was not reasonably foreseeable that non-charging advances could be used for the purpose of exiting the loan facility.[118]

The "presumed intention" approach

It is submitted that a bond trust is fundamentally different from a paradigm trust structure. It resembles more of a commercial multi-party contract than a traditional trust (for example, a family trust). Therefore, traditional trust law is not suited to bond trusts. The issue of causation under bond trusts should be addressed in a contract law framework. Specifically, whether a

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114 At 251.

115 At 251.

116 At 251. While it was true that, under cl 3 01 of the trust deed, Comsec also acknowledged an indebtedness to Guardian Trust in respect of the security stock, the security stock itself was only a security for Comsec's obligations under the loans. It was not suggested by the plaintiff that the value of the security was damaged or diminished.

117 At 253.

118 At 254.

party should be liable for the loss suffered by the other party should be determined based on the presumed intention of the parties, that is, what the parties would have agreed had they turned their minds to the particular question.

The bond trust is fundamentally different from a traditional trust structure. Under a typical trust, the settlor transfers certain assets (for example, a family house) to the trustee, who holds the asset on trust for the benefit of the beneficiaries. The key advantages of setting up a traditional trust include protecting the assets from the settlor's insolvency or from bankruptcy risks, and ensuring that the beneficiaries, while having the benefits of the trust assets, do not have managerial control. In contrast, the trust property under a bond trust is a bundle of rights and powers, the key one being the chose in action against the bond issuer. Setting up a bond trust offers no protection against the settlor's insolvency risk, because the settlor is also the debtor of the chose in action. Nor is the bond trust's purpose to ensure that the beneficiaries have no control over the trust assets. On the contrary, the beneficiaries – the bondholders – can give instructions to the bond trustee regarding the management of the trust assets. The key reason why a bond trustee is appointed is not to safeguard the trust assets, but to act as the collective agent on behalf of the bondholders.

The commercial contractual nature of bond trusts has been recognised by English courts in recent cases. In *Citibank NA v MBIA Assurance SA*, the Court of Appeal held that a bond trustee can contract out of its fiduciary duty to act in the best interests of beneficiaries.[119] This decision echoed the famous dictum of Mason J in *Hospital Products Ltd v United States Surgical Corp* (quoted with approval by Lord Browne-Wilkinson in *Kelly v Cooper*)[120] "[t]he

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119 *Citibank NA v MBIA Assurance SA* [2007] EWCA Civ 11. For discussion of this case within a traditional trust law framework, see Alexander Trukhtanov "The Irreducible Core of Trust Obligations" (2007) 123 LQR 342.

120 *Kelly v Cooper* [1993] AC 205 (PC) at 215.

fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them".[121]

In the context of bond trusts, the issue of causation, similarly to many other issues, is ultimately a matter of contractual interpretation.[122] Like other commercial contracts, a bond trust deed simply cannot provide for every possible factual scenario in which the bondholders may suffer loss. Therefore, the proper question to ask is, based on the terms of the trust deed and other relevant circumstances, what would the parties have agreed to had they turned their minds to the issue of causation?

Adopting the "presumed intention" approach to the *BNZ* case, the test for causation becomes this: is the parties' presumed intention that Guardian Trust should be held liable in the situation where its breach did not lead to the reduction of the value of the secured assets, but resulted in the loss of the early exit opportunity? The answer seems to be reasonably clear. Guardian Trust was appointed as a security trustee, its primary role being to hold the security interest on behalf of each bank. Therefore, it is likely that, had the parties considered this question when entering into the bond trust deed, they would have agreed that Guardian Trust should not be liable to the banks, as long as its breach had not caused the reduction of the value of the charged assets. This conclusion is further supported by the fact that the early exit right was provided under the loan document, not under the trust deed.

In terms of bonds regulated by the FMC Act, the presumed intention in question is not of the parties, but of Parliament, because the bond supervisors' duties are statutory duties imposed

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121 *Hospital Products Ltd v United States Surgical Corp* (1984) 156 CLR 41 at 97. See further Sir Peter Millett "Equity's Place in the Law of Commerce" (1998) 114 LQR 214.

122 For discussion of the modern approach of contractual interpretation, see *Investors Compensation Scheme Ltd v West Bromwich Building Society* [1998] 1 WLR 896 (HL); *Vector Gas Ltd v Bay of Plenty Energy Ltd* [2010] NZSC 5.

by Parliament.[123] In contrast to *BNZ* where the lenders were banks, bondholders who invest in regulated bonds are likely to be retail investors. Compared to banks, retail investors place more expectations and reliance on bond supervisors. Therefore, it could be argued that Parliament intended that the bond supervisor would be held liable as long as the *but for* test was met (the distant nexus approach). On the other hand, the language of s 496 of the FMC Act suggests that a distant nexus approach for the bond supervisors' liability is unlikely.[124]

Under s 496(2) and (3), if the offering document of the bonds contains a material misstatement and the bonds have declined in value thereafter, any investor who acquired the bonds under the offer must be treated as having suffered loss or damage because of the misstatement. However, the issuer can rebut the presumed causation by showing that the decline in value was caused by a matter other than the misstatement.[125] In other words, even if the investor can prove that it would not have invested in the bonds but for the misstatement (thereby meeting the *but for* test), the issuer could still avoid liability if it proves that the loss was caused not by the misstatement, but by other factors (for example, deterioration in the economic environment). While reversing the burden of proof, s 496 stops short of adopting a distant nexus approach for issuer liability for misstatements. Therefore, it seems unlikely that Parliament could have intended to adopt a distant nexus approach for bond supervisors.

Burden of proof

No matter whether the close nexus approach or the distant nexus approach applies, the bondholders still need to prove, on the balance of probabilities, the existence of the alleged

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123 See *Purdue v Perpetual Trust Ltd*, above n 55, at [38].

124 For discussion of s 496, see Ross Pennington "Financial Markets Conduct Act 2013 – How It Creates a Fundamental Shift in Capital Raising and in the Role of Facilitators and Gatekeepers" (paper presented to the 31st Annual BFSLA Conference, Queenstown, 2014) at 39–43.

125 FMC Act, s 496(3).

causal link. A United States case, *Semi-Tech Litigation, LLC v Bankers Trust Co* (*Semi-Tech*), provides an illustration where the alleged causal link was not proved.[126]

In this case, Semi-Tech Corporation (the issuer) issued USD 300 million bonds to fund its purchase of 51 per cent of the shares of the Singer Company NV (Singer). The bonds were charged against the shares in Singer held by the issuer. Bankers Trust Company (Bankers Trust) was appointed as indenture trustee for the bonds. Singer entered into certain transactions (the prohibited transactions) in breach of the trust indenture. The prohibited transactions contributed to Singer's bankruptcy, causing losses to the issuer and, in turn, the bondholders. Under the trust indenture, the issuer provided certain director certificates to Bankers Trust. The certificates did not conform to the statutorily prescribed language. The plaintiff held the assigned claims of certain bondholders. It alleged that Bankers Trust breached its duties by failing to properly examine the certificates provided by the issuer, and such breach caused the bondholders' loss.

After concluding that Bankers Trust had breached its duty to properly examine the certificates,[127] the Court turned to the issue of causation. The plaintiff claimed three alternative causal links. First, the plaintiff argued that, had the trustee discovered the breach, it would have notified the bondholders, and the bondholder would have taken actions to protect their interests. This causal link was rejected by the Court because the plaintiff had not provided any evidence to show that the trustee would have notified the bondholders of the issuer's breach.[128] The second causal link alleged by the plaintiff was that, had the trustee examined the nonconforming certificates and sought conforming ones, it "may well have uncovered serious problems at Semi-Tech" and triggered an event of default, therefore protecting the bondholders.[129] The

126 *Semi-Tech Litigation, LLC v Bankers Trust Co* 353 F Supp 2d 460 (SD NY 2005).

127 At 478.

128 At 485.

129 At 486.

Judge rejected this argument because, under the United States law, the trustee had no duty to inquire into the matters stated in the certificates.[130] The plaintiff also alleged a third causal link, arguing that, had the trustee observed its duties, the directors of the issuer would have been more observant of the indenture covenants, and the prohibited transactions would not have occurred.[131] Again this argument was rejected due to a lack of evidence.[132]

It is noteworthy to add that, if *Semi-Tech* were to be decided under New Zealand law, the second causal link might well be established. Unlike the United States law, bond supervisors in New Zealand do have duties to monitor the issuer's performance. Therefore, it is at least arguable that, had the bond supervisor properly performed its monitoring duties, it might have found out the prohibited transactions, and declared the bonds to be immediately repayable, thereby preventing or reducing the loss of the bondholders.

In conclusion, given the fundamental differences between a bond trust and a traditional trust, the issue of causation should be analysed as a matter of interpretation of contractual terms (express or implied) and the applicable statutory provisions.

4.5 A proposed monitoring model

4.5.1 The necessity of a monitoring agent in the New Zealand bond market

As discussed above, the monitoring duties imposed under New Zealand law are much more onerous than those under English law or the United States law. It is unreasonable to expect bond supervisors to comply with these duties. However, due to the unique nature of the New Zealand bond investor base, it is necessary to have a monitoring agent to protect the

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130 At 486.

131 At 486. The prohibited transactions were entered into by Singer, not Semi-Tech. Although not mentioned in the judgment, it is likely that the directors of Semi-Tech had control over Singer, given that it was the majority shareholder of Singer.

132 At 486.

interests of investors. Unlike the situation facing bond investors in London or New York, a large proportion of New Zealand corporate bond investors are retail.[133] Generally speaking, retail investors are not capable of assessing the risks associated with investing in bonds, such risks including the issuer's credit risk, legal and regulatory risk, market interest risk, other economic risks and their interactions with each other.[134] In New Zealand, retail bond investors face additional difficulties: financial illiteracy and a lack of an independent financial advisory sector.

While all investors suffer from various cognitive biases, retail investors are particularly vulnerable. For example, Trevor Ludlow, former director of the failed finance company National Finance 2000 Ltd, visited a potential investor with flowers while she was hospitalised and left with a $65,000 investment.[135] In another example, certain finance companies deliberately set the interest rate on their debt securities to a small margin above bank deposit rates, knowing that gullible investors would simply equate low return rate with a low credit risk.[136]

Retail participation in the corporate bond market is likely to continue in New Zealand. While other measures, such as enhancing investor education and expanding the independent

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133 The total amount of bonds issued by failed finance companies is around $9 billion, the majority of which was purchased by retail investors. This amount is roughly 30 per cent of the total size of corporate bonds outstanding (as of 2014). By comparison, the total amount of retail corporate bonds issued in the United States in 2012 is around USD 11 billion, less than one per cent of the total issue size of corporate bonds. See <www.interest.co.nz/saving/deep-freeze-list>; Reserve Bank of New Zealand *A Primer on New Zealand's Capital Markets* (Bulletin Vol 78, No 3, May 2015) at 13; Rohini Tendulkar and Gigi Hancock "Corporate Bond Markets: A Global Perspective" (OICV–IOSCO SWP4/2014, February 2014) <www.iosco.org> at 48; Securities Industry and Financial Markets Association *US Corporate Bond Issuance* (updated 2 March 2016).

134 Tendulkar and Hancock, above n 133, at 46.

135 See Nick Krause, Fiona Rotherham and William Mace "National Finance Sentence 'Nothing' Compared to Losses" (21 October 2001) Stuff <www.stuff.co.nz>.

136 Commerce Committee, above n 18, at 11.

advisory sector, will mitigate the hardship of retail investors, a mandatory bond supervisor regime will remain the key regulatory measure to protect the investing public.

4.5.2 A tentative model: direct supervision by the FMA

The current supervision model for regulated bonds is two-tiered: trustee companies, acting as bond supervisors, perform a semi-regulatory role;[137] bond supervisors are licensed and supervised by the FMA. Leaving aside the issue of the appropriateness of privatisation of regulatory supervision and oversight, this two-tier model is complex and potentially confusing.

Under the current regime, the FMA directly interacts with the issuers. It receives and reviews the disclosure documents and trust deeds of regulated bonds. Bond supervisors must report contraventions or serious financial problems to the FMA, and the FMA may issue directions to the bond supervisor or to the issuer directly.[138] By allowing the FMA to step into the trustee companies' shoes, it could potentially blur the boundary between the FMA as regulator and trustee companies as bond supervisors and give rise to public expectations around the FMA's supervision role,[139] notwithstanding the assertions that trustee companies are to act as the frontline supervisors.[140] Therefore, it is worthwhile to consider a new centralised regulatory model: the FMA would act as the supervisor for all regulated bonds, with trustee companies exiting from the retail bond sector altogether. In this way, trustee companies would then operate only in the wholesale bond markets, with the freedom of setting the level of

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137 Section 16(2)(a) of the Financial Supervisors Act 2011 provides that only companies are qualified to be a licensed supervisor.

138 FMC Act, ss 203–206 and 468.

139 Office of the Minister of Commerce "Improving the Supervision of Issuers by Trustees" (August 2009) at [68].

140 For a similar proposal regarding direct supervision of non-bank deposit takers by the Reserve Bank, see Nicola Won "Regulation of Finance Companies: Coming Out of the Shadows" (2015) 21 NZBLQ 110 at 119–120.

monitoring and other functions as they see fit. Their responsibilities would be aligned with those of their overseas counterparts.

In a 2009 Cabinet paper, the idea of direct supervision by a central regulator was considered but then rejected for three reasons: it had the potential to result in a significant increase in costs to the government, issuers and investors; it might be difficult for the regulator to establish a sufficiently large pool of qualified people to perform the supervisory function; and the issuers might be less willing to disclose information to a regulator as opposed to a trustee.[141] It is proposed that each of these concerns was probably overstated.

First, there are reasons to believe that, if the FMA is to act as the bond supervisor for all regulated bonds, the overall compliance costs may decrease through the economies of scale. Compared to the overseas markets, the bond supervisor sector in New Zealand is very fragmented. There are six licensed bond supervisors, while the total number of corporate bond issuers is likely to be in the double digits. Such fragmentation is likely to result in inefficiency and an overlap in functions across the bond supervisor sector.

Secondly, it is questionable whether adopting the direct supervision model will require a substantial increase in personnel. It appears that the FMA has already built up a team of qualified professionals who currently review all filed documents of regulated bonds, and monitor all six licensed bond supervisors. Furthermore, if additional manpower is required in a certain situation, the FMA can seek external assistance from investigative accountants, legal advisers and trustee companies on an *ad hoc* basis.

In terms of access to information, compared to trustee companies, the FMA is arguably in a better position. A trustee company only has access to the information of the issuers which it supervises. The FMA, on the other hand, can obtain information not only from every

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[141] Office of the Minister of Commerce, above n 139, at [62]–[64].

regulated bond issuer, but also from the other regulators, such as the Reserve Bank of New Zealand and NZX.[142] This places the FMA in an ideal position to take a uniform risk-based approach to monitor the issuers' performance and to take necessary actions in challenging situations.

There are other reasons why the direct supervision model is preferable to the current model. First, having the FMA to act as the bond supervisor would remove the inherent conflict of interest in the bond trust structure – trustee companies are appointed and paid by the issuers, yet they are responsible for supervising the issuers. Trustee companies have been criticised for failing to ask for strong bond covenants.[143] However, while it is true that they should act for the benefit of bondholders only, that duty does not arise until the bonds have been issued. During the negotiation stage, trustee companies, as commercial entities seeking profits, have no duty to seek strong bond covenants for the purpose of protecting future investors. In contrast, one of the FMA's overarching goals is to protect investors, not profit-making. If the FMA were to act as the bond supervisor, it could utilise its soft regulatory powers to seek proper bond covenants during the negotiation stage.

In addition, under the existing regime, if a trustee company fails to comply with its duties as the bond supervisor, the FMA is able to take legal action against the trustee company, using its powers under s 489 (pecuniary penalty order) or s 494 (compensation order) of the FMC Act, or s 34 of the FMA Act. However, the FMA also has the power to give directions to the issuer or the trustee company. This might be unworkable in practice.[144] Having the FMA act as the bond supervisor would eliminate this potential problem.

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142 See Memorandum of Understanding between the FMA and the Reserve Bank of New Zealand, dated 9 September 2011; Memorandum of Understanding between the FMA and NZX Ltd, dated 28 January 2015, both available at <www.fma.govt.nz>.

143 Commerce Committee, above n 24, at 10.

144 Office of the Minister of Commerce, above n 139, at [68].

One concern about the direct supervision model is the increased potential liability of the FMA. Under this model, the FMA, as the bond supervisor, would be subject to the monitoring duties and other duties under the FMC Act. Therefore, it could be sued, and found liable for, negligent performance.[145] Given that the FMA is funded by the taxpayers' money, effective arrangements will need to be put in place to ensure that the taxpayers will not have to compensate investors in case of bond defaults. Currently, trustee companies cover the risk of negligent performance by liability insurance, and the premiums are paid from the trustee fees. If the FMA is to act as the bond supervisor for all retail bonds, presumably the trustee fees would then be paid to the FMA, which could be used by the FMA to cover the costs of purchasing liability insurance.

It might be added that, although the FMC Act does not provide for a bond supervisor to seek directions from the FMA, it does require the bond supervisor to report breaches or possible breaches of the issuer's obligation or serious financial problems to the FMA,[146] and allows the FMA to give directions to the bond supervisor.[147] Therefore, from a risk mitigation perspective, trust companies may take advantage of this by frequently seeking directions from the FMA. If the FMA refuses to give a direction, it might be more difficult for the FMA to take regulatory or legal actions against the trustee company at a later stage.

4.6 Conclusion

The failure of the finance company sector has dealt a serious blow to the confidence of New Zealand investors. As a result, the regulatory regime for financial products issued to the public has been revamped and strengthened. Under the FMC Act, stringent monitoring duties

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145 Under s 22(1) of the FMA Act, the FMA is not liable for anything it may do or fail to do in the course of the performance of its duties unless it acted in bad faith or without reasonable care.

146 FMC Act, ss 203–204.

147 FMC Act, ss 205–206.

and heightened conduct standards have been imposed on bond supervisors. In addition, the term "trustee" is now replaced by the more appropriate term "supervisor".

However, the regulatory approach, centred around monitoring duties, fails to take into account the difficulties involved in actively monitoring, and the character of the trustee company sector. As a result, there are serious doubts as to whether the monitoring duties are able to achieve their purposes. In fact, even before the recent securities law reform, the regulatory regime for bond trustees in New Zealand was already one of the toughest in the world. Yet it failed to prevent the finance companies' collapse.

Perceiving the shortcomings of the current regime, a new supervision model for retail bonds is proposed: the FMA is to act as the bond supervisor for all retail bonds. Compared to trustee companies, the FMA has more powers and access to greater information, and its judgement will not be affected by conflicts of interest.

From the trustee companies' perspective, they will be well advised to take all available measures to control and reduce their legal and regulatory risks. Seeking external legal advice and directions from the court should be preferred, as such actions could serve as evidence that the due diligence standard and the prudent supervisor standard have been complied with.148 Trustee companies should also take extra care when reviewing draft trust deeds. For example, repeating the monitoring duties in the trust deed should be avoided, because having such duties set out in the trust deed may lead the court to conclude that such duties are owed to the issuer as well as to bondholders. It may be advantageous to expressly exclude any contractual duties to the issuer, together with any tortious liabilities to the issuer, the bondholders, or prospective investors.

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148 In *Fenton v Pakuranga Park Village Trust* HC Auckland CP 269/96, 23 December 1996, at 40, Baragwanath J of the High Court criticised Guardian Trust for not seeking court directions.

CHAPTER 5 THE CONTRACTUAL NATURE OF BOND TRUSTS AND SECURITY TRUSTS

5.1 Introduction

Bond trust structures and security trust structures are nowadays widely used in financial transactions. However, with a few exceptions, they have attracted relatively little critical attention from the English legal academic community. This is probably due to the small number of cases involving disputes between the bond trustee or security trustee on the one hand, and the beneficiaries (ie the bondholders and the secured creditors) on the other.[1] When such disputes do arise, they are treated by the courts similarly to other express trust disputes. Specifically, the rights and duties of the trustee are analysed in the orthodox trust law framework, taking into account the terms of the relevant trust deed.[2]

It is submitted that bond trusts and security trusts are fundamentally different from other types of express trust. The *in rem* feature, the key ingredient of all other express trusts, is absent in bond trusts and security trusts, which should therefore be regarded as multilateral contracts among the parties, and the legal issues should be analysed in the contract law framework. In particular, bond trustees and security trustees are not trustees in any traditional sense; rather, they are collective agents of the bondholders/secured creditors. Their role is not to safeguard and administer the trust property, but to make decisions and take actions on behalf of the bondholders/secured creditors.

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1 Cases involving bond trusts or security trusts are usually brought by the trustee against the bond issuer or the grantor of the security interest.

2 Some cases are purely a matter of interpretation of the trust deed terms. For recent examples, see *Concord Trust v Law Debenture Trust Corp Plc* [2005] UKHL 27; *Re Sigma Finance Corp (in admin rec)* [2009] UKSC 2; *BNY Mellon Corporate Trustee Services Ltd v Taberna Europe CDO I PLC* [2016] EWHC 781 (Ch); *The Australian Special Opportunity Fund LP v Equity Trustees Wealth Services Ltd* [2015] NSWCA 225.

The purposes of this chapter are, therefore: to assess the unique characteristics of the trust property of bond trusts and security trusts, and what these characteristics entail; to propose a contractual approach for bond trusts and security trusts; and to apply this approach to two Court of Appeal cases, one from the United Kingdom and one from New Zealand. First, however, it is necessary to give a brief overview of the bond trust structure and the security trust structure, and to discuss the current English law framework applicable to these structures.

5.2 Bond trusts and security trusts – current law and practice

Most corporate bonds[3] are issued under a trust structure.[4] Under a bond trust, the issuer grants a number of covenants (including a covenant to pay the principal and interest on the bonds) to the trustee, to be held on trust for the benefit of the bondholders. The role of a bond trustee is three-fold: monitoring; granting modifications, waivers and other consents; and enforcement.[5] The key advantage of having a bond trustee is that it provides a solution to the collective-action problem which the bondholders would have to face if no trustee were appointed.[6] Having a bond trustee is also advantageous to the issuer, as it provides the issuer protection against "mad bondholders" through the no-action clause in the trust deed. Under this

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3 In this chapter, the term "bond" is used in a generic sense and includes bonds, notes and debentures, whether secured or unsecured.

4 Occasionally, a company may issue bonds only to a few institutional investors. In such cases, the bonds may be issued without a trust structure.

5 Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 17–21.

6 For further discussion of the advantages and disadvantages of having a bond trustee, see Philip R Wood, *International Loans, Bonds, Guarantees, Legal Opinions* (London: Sweet & Maxwell, 2nd ed, 2007) 285–288; Margery A Colloff "The Role of the Trustee in Mitigating Fraud in Structured Financings" (2005) 10(4) *The Journal of Structured Finance* 73. The importance of bond trustees is shown in insolvency cases where, with the relevant bankrupt issuer not having appointed a trustee, the court had to appoint a trustee to act as the representative of all bondholders. See Kyong Lee and Karkus Heidinger "Bondholders in Insolvency Proceedings against an Austrian Issuer – the Maculan Case" (1998) 13 JIBL 118.

clause, individual bondholders are not allowed to take actions against the issuer unless certain strict conditions are met.[7]

A security trust refers to a structure under which a borrower[8] grants a security interest to a trustee who holds it on trust for the secured creditors. Security trusts are typically used in syndicated loans, securitisations and other financing structures where the security interest needs to be given to multiple parties. The fact that the security interest is legally held by the trustee enables the transfer of a secured obligation from a current lender to a new lender without the security interest having to be re-registered.[9] In terms of secured bonds, usually the bond trustee also acts as the security trustee.

The primary source of the rights and duties of bond trustees and security trustees is in the trust deed itself. Case law and, to a limited extent, statutes, also apply. Under the general trust law, trustees are subject to fiduciary duties and a duty of care. While the general position is that the duty of care may be excluded,[10] s 750(1) of the Companies Act 2006 (UK) prohibits such an exemption in respect of bond trustees. There are different views as to whether this provision applies only to bonds issued by UK companies,[11] or if it applies to all bonds

7 For general discussion of no-action clauses, see Philip Rawlings "Reinforcing Collectivity: The Liability of Trustees and the Power of Investors in Finance Transactions" (2009) 23 *Tru L I* 14; Benjamin Liu "No-action Clause in Bond Trust" (2014) 25 JBFLP 1.

8 It is possible that the security is not given by the borrower, but by a guarantor. For discussion purposes, this chapter assumes that the borrower is the grantor of the security interest.

9 Louise Gullifer and Jennifer Payne *Corporate Finance Law: Principles and Policy* (Hart Publishing, London, 2011) at 333.

10 *Armitage v Nurse* [1998] Ch 241 at 254, per Millett LJ; Compare *Spread Trustee Company Ltd v Sarah Ann Hutcheson and Others* [2011] UKPC 13 at [137], per Lady Hale; at [166], per Lord Kerr. For an excellent survey of the modern law of fiduciary duties in general, see *Bristol and West Building Society v Mothew* [1998] Ch 1.

11 Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London, 2009) at 151; Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 4.

governed by English law.[12] In practice, bond trust deeds and security trust deeds governed by English law almost inevitably include a provision that is similar to s 750(1). Other than the duty of care, bond trust deeds and security trust deeds impose few, if any, substantive duties on the trustee.

Typically, bond trust deeds and security trust deeds contain extensive provisions for the trustee's powers. In terms of bond trustees, such powers include the power to request the issuer to provide certain financial information or certificates (such as a certificate stating that no event of default has occurred), the power to request a bondholders' meeting, other administrative powers and, most importantly, the power to declare the occurrence of an event of default and to take enforcement actions against the issuer. If an event of default has occurred, the crucial power of a security trustee is to enforce the security interest. While a trustee's decision to exercise or not to exercise a power is subject to judicial review, the courts do not intervene unless the decision is "so outrageous in its defiance of reason that it can properly be categorised as perverse".[13]

5.3 Comparing bond trust and security trusts with other express trusts

Broadly speaking, there are two theories of trusts. The first one is the proprietary theory. Under this theory, once the legal title of a property is separated from its beneficial title, a trust is validly created. As Lord Lindley famously observed, "[a]ll that is necessary to establish the relation of trustee and *cestui que trust* is to prove that the legal title was in the plaintiff and the equitable title is in the defendant… Being provided, no matter how, the relation of trustee and *cestui que trust* was thereby established."[14] The obligational theory of trusts, on the other hand,

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12 Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 237.

13 *Ludgate Insurance Company Ltd v Citibank NA* [1998] Lloyds LR 221 at [35], per Brooke LJ.

14 *Hardoon v Belilios* [1901] AC 118 (PC) at 123.

views trusts primarily as a species of obligation. Nevertheless, under the obligational theory the importance of the trust property is recognised: the trustee's obligations are to hold the trust property and distribute it in accordance with the trust.[15]

It is apparent that under both theories of trusts the *in rem* feature is essential. Indeed, the persistence of the beneficiary's interest against all other parties, except a bona fide purchaser without notice, is the key reason of the proliferation of the use of trust structures in modern finance.[16]

It is submitted that, in the context of bonds trusts and security trusts, the nature of the trust property is fundamentally different from that of other types of express trust. Unlike a typical express trust (for example, a family trust), the trust property of a bond trust or security trust does not have an independent economic value and cannot be disposed of by the trustee. As a result, from a beneficiary's perspective the trust structure of bond trusts and security trusts does not provide the same level of protection against the settlor's credit risk as do other express trusts. Nor is the beneficiary concerned with trustee risks (such as insolvency or unlawful disposal of trust property) as are the beneficiaries of a traditional express trust.

5.3.1 Bond trust

Generally speaking, bond trusts may be structured in three ways: a stock structure, in which the issuer grants a covenant to pay only to the trustee; a US trust indenture, in which the

15 See for example Charles Rickett "The Classification of Trusts" (1999) 18 NZULR 305 at 308–309; Peter Jaffey "Explaining the Trust" (2015) 131 LQR 377 at 378.

16 Alexander Trukhtanov "The Irreducible Core of Trust Obligations" (2007) 123 LQR 342 at 346. For a list of financial transactions in which trustees are involved, see Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 7–14.

issuer grants a covenant to pay only to the bondholders; or a bond structure, in which the issuer grants a covenant to pay both to the trustee and to each bondholder.[17]

A stock is created by a trust deed between the issuer and the trustee.[18] The stock constitutes one single debt, and each stockholder (i.e., the lender) owns a beneficial interest in an undivided portion of the stock. Under the trust deed, the issuer grants a covenant to pay to the trustee. The issuer does not grant a covenant to pay to the stockholders. Because of this, for the purposes of a winding up, administration or scheme of arrangement, the stockholders are not creditors of the issuer, because they "have not any direct contract with the company."[19] In essence, the trust deed is the loan contract between the issuer and the trustee; it also constitutes the trust under which the trustee holds the chose in action on trust for the stockholders. The stock structure is used mostly in UK domestic issues, and its popularity is in decline.[20] Among the three alternative structures, stock probably bears the most resemblance to a typical express trust.

Bonds governed by US law are usually issued under a trust indenture (the equivalent of an English bond trust deed). The standard practice is that the issuer grants a covenant to pay only to the bondholders, not to the trustee. This means that, apart from some contingent trust assets,[21] the indenture trustee holds no assets. This has led to the view that a US bond trust is not a trust at all.[22]

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17 In addition to the covenant to pay, usually the issuer also grants other covenants. The discussion here focuses on the covenant to pay.

18 Types of stocks include loan stock (unsecured), first mortgage debenture stock (secured by a first-ranking fixed mortgage or charge), and debenture stock (secured by a floating charge).

19 *In Re Dunderland Iron Ore Company, Ltd* [1909] 1 Ch 446 at 452, per Swinfen Eady J.

20 Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at [3.3].

21 For example, the funds recovered by the trustee from the issuer for further distribution to the bondholders.

22 Steven L Schwarcz "Commercial Trusts as Business Organizations: Unraveling the Mystery" (2003) *The Business Lawyer* 559 at 569; *Hazzard v Chase National Bank* 159 Misc 57 (NY Sup Ct 1936); *Elliott*

In today's debt capital markets, most international corporate bonds and certain UK domestic bonds governed by English law are issued under a bond trust structure. Under the bond trust deed, the issuer grants a covenant to pay to the bond trustee, which is held on trust by the trustee for the bondholders. At first glance, a bond trust appears to fit nicely into a typical express trust structure – the bond trustee obtains the legal title of the covenant, and the bondholders own the beneficial title.[23] However, unlike in a stock structure, bonds are issued by the issuer directly to the bondholders.[24] Each bond contains a direct covenant to pay, granted by the issuer to the bondholder. Payment to the trustee or the bondholders will automatically discharge the issuer's obligation to the other.

The covenant to pay given to the bondholders is necessary because it ensures that the bondholders have a full legal title to the bonds, a requirement for the bearer bonds to be recognised as negotiable instruments.[25] In addition, bonds are traded internationally today. In certain countries, only the legal title, not the beneficial title, is recognised under local laws.[26]

Associates v J Henry Schroder Bank & Trust Co 838 F 2d 66 (2nd Cir 1988). For general discussion of US trust indentures, see Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) 42 Harv L Rev 198; Martin D Sklar "Corporate Indenture Trustee: Genuine Fiduciary or Mere Stakeholder" (1989) 106 Banking LJ 42.

23 Tennekoon, n 12 above, at 226; *Bank of New Zealand v NZ Guardian Trust (Co)* [1999] 1 NZLR 213, 249 (NZHC) (the *BNZ* case).

24 Nowadays, most international bonds are issued through a global note structure. The global note is held by the International Central Securities Depositories on behalf of account holders. For the purposes of this chapter, it is assumed that bonds are issued to and held by investors directly. For further discussion, see Joanna Benjamin and Madeleine Yates *The Law of Global Custody* (2nd ed, Butterworths, London, 2002).

25 Fuller, n 20 above, 15.8. The issue of negotiability has been complicated by the fact that most bonds issued in the Eurobond markets today are dematerialised. See Joanna Benjamin and Madeleine Yates *The Law of Global Custody* (2nd ed, Butterworths, London, 2002) at 16–21.

26 Gullifer and Payne, n 9 above, 335; Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd ed, Sweet & Maxwell, London, 2007) at [16.015–16.106].

In a normal express trust, the trust property is paramount – it has an independent economic value, and the trustee is appointed to perform duties *in respect of the trust property*. In contrast, under a bond trust, the nature of the trust property is circular – the issuer grants a covenant to pay to the bond trustee because a trustee cannot be appointed unless it holds identifiable trust property.[27] This covenant to pay has no independent economic value, the economic value lies with the chose in action under the bonds. In fact, the most important consequences of the bond trustee's actions are in respect of the bonds. In particular, the enforcement action taken by the bond trustee against the issuer will dictate how much the bondholders will ultimately recover *under the bonds*. The bonds are not part of the trust property.[28]

Under a typical express trust, once a trust is created, the trust assets cease to be part of the general assets of the settlor. Therefore, if the settlor becomes insolvent, the beneficiary's proprietary interest in the trust assets remains protected. For example, in a pension trust structure, once the employer has transferred its contributions to the trustee, the funds legally belong to the trustee, not the settlor. If the employer becomes insolvent, the beneficiaries, i.e., the employees, are protected.

For bond trusts, the general view is that the issuer is the settlor.[29] Therefore, a trust structure offers no extra protection to the bondholders against the credit risk of the settlor. In fact, the concern that the term "trustee" gives less sophisticated investors a false sense of security has recently prompted New Zealand law-makers to replace the term "trustee" with a more appropriate term "supervisor" in the recent financial law reform.[30]

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27 Alastair Hudson *The Law on Investment Entities* (Sweet & Maxwell, London, 2000) at [6.10]; Gullifer and Payne, n 9 above, at 334.

28 Tennekoon, n 12 above, at 226; Fuller, n 20 above, 3.10; *BNZ*, n 23 above, at 252.

29 Tennekoon, n 12 above, at 226.

30 Commerce Committee (NZ) *Inquiry into Finance Company Failures* (October 2011) <www.parliament.nz> at 27; Financial Markets Conduct Act 2013 (NZ), Part 4, Subpart 1.

Another benefit offered by the *in rem* feature of a normal trust structure is that it protects the trust property from third parties, except for bona fide purchasers for value without notice. For example, in an investment trust under which investors pool their funds together to invest in securities, the trustee is the legal owner of the trust assets. If the investment trustee disposes of those assets in breach of trust, and the recipient is aware of the breach, the investors are entitled to request the recipient to return the trust assets. The trust assets are also protected against the general creditors of the trustee in case of the trustee's insolvency.

Obviously the chose in action owed by the issuer to the bondholders can only be transferred through a transfer of bonds. Therefore, there is a strong inference that any purported assignment of the parallel covenant to pay granted to the bond trustee is implicitly prohibited, except in case of a transfer of the trusteeship. In any event, it is unlikely that a fraudulent bond trustee would be able to find any potential buyer, given the lack of independent economic value of this covenant to pay. Protection against trustees' risks, valued by beneficiaries in other types of express trusts, is simply not an issue in bond trusts.

5.3.2 Security trust

Under a security trust, the debtor grants a security interest to the trustee who holds it on trust for the benefit of the secured parties.[31] The secured parties may include bank lenders, bondholders, derivative counterparties, and credit enhancement providers. The fact that the security interest is legally held by the security trustee eliminates the need to transfer and re-register the security interest when a secured party transfers its rights to a third party. The main duty of a security trustee is to enforce security following an event of default and distribute proceeds in accordance with the priority of payments as specified in the security trust deed.

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[31] See generally Paul U Ali (ed) *Secured Finance Transactions: Key Assets and Emerging Markets* (Globe Business Publishing, 2007).

Compared to bond trusts, it seems less difficult to fit a security trust into the paradigm of a trust structure. After all, the trust property in question, the security interest, is a proprietary interest.[32] It needs to be emphasised at the outset, however, that it would be wrong to equate the security interest with the charged assets over which the security interest is granted. While clearly related, conceptually they are two different things. The economic value of the underlying assets is reflected in the estimated price for which these assets can be realised, whereas the economic value of the security interest is reflected in the proportion of the amount of the secured obligations to the estimated selling price of the charged assets, taking into account the probability that the actual selling price is less than the estimated selling price. In most cases, if the estimated selling price of the underlying assets drops, the economic value of the security interest will also fall. However, this is not necessarily always the case. This point can be illustrated by a simple example. Let us assume that the estimated selling price of the underlying assets is $100 million, and the total amount of the secured obligation is $1 million. Later, if the estimated selling price drops to $80 million (a 20 per cent decrease), the economic value of the security interest will change little if at all. This is because the reduced estimated selling price ($80 million) still far exceeds the total amount of the secured debts ($1 million).

Obviously, the beneficiaries (i.e., the secured creditors) under a security trust enjoy the *in rem* protection. If the charged assets are disposed of by the borrower, or if the borrower is insolvent, the beneficiaries' interests, subject to certain exceptions, are protected. However, such protection is because of the *in rem* nature of the security interest, not because of the *in rem* nature of the security trust. In other words, if the security interest were granted to each secured party directly, rather than being held by the security trustee, the secured creditors would enjoy the same level of protection.

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32 Gullifer and Payne, n 9 above, at 334.

Strictly speaking, from a credit risk perspective, the protection enjoyed by the beneficiaries of a security trust is less than the protection offered by a traditional express trust. For a security trust, the assets still belong to the borrower. The protection enjoyed by the beneficiaries may be impaired by defects in the registration of the security interest; and will also be defeated by a bona fide purchaser for value without notice. The beneficiaries under a normal express trust do not have to be concerned with settlor risks.

As a general rule, a security interest cannot be transferred alone; it can only be transferred together with the secured obligations. Therefore, unlike the usual kinds of trust property under a typical express trust, the trust estate under a security trust has no independent economic value. Because of this, it is simply not possible for a security trustee to dispose of the security interest. Nor does a security interest form part of the general assets of the security trustee available for its general creditors in case of an insolvency.

In conclusion, bond trusts and security trusts do not share the *in rem* feature with other express trusts. The beneficiaries under a bond trust or a security trust do not enjoy the same protection as those in other express trusts. The lack of the *in rem* feature leads to a number of fundamental trust law rules, such as the trustee's duty to account and the power to invest, being of no relevance to bond trusts and security trusts. Nor are certain proprietary remedies for breaches of trust, such as surcharge and falsification, applicable.[33]

5.4 The contractual nature of bond trusts and security trusts

Various aspects of the contractual nature of bond trusts and security trusts have been recognised by the courts and commentators. For example, the courts have little trouble treating

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33 The remedy of account of profits may be available where the bond trustee makes an unlawful gain by abusing its position. However, in such cases, the account of profits is available because of the fiduciary nature of the relationship between the bond trustee and the bondholders, instead of the *in rem* nature of the bond trust.

the legal relationship between the issuer and the bond trustee as a contract.[34] This should come as no surprise, given that the issuer/borrower and the trustee sign the trust deed. The dual nature of trust and contract is also recognised in the context of the relationship between the trustee and the bondholders/secured creditors. While the bondholders/secured creditors do not usually sign the trust deed, the courts are able to get around this difficulty by either deeming the relationship as a trust and a contract, or resorting to the statutory protection offered to non-contracting parties.[35] In fact, very often the courts discuss the issues purely as a matter of interpretation of the trust deed terms, an approach not very different from treating the trust as a contract.[36]

However, from time to time, in cases where the terms of the trust deed do not provide a clear answer to the issue involved, the court will be obliged to resort to the rules and principles of trust law, given that the relationship is a trust. Furthermore, there are cases where the trust deed provisions conflict with trust law rules. In the spirit of upholding the commercial arrangements of the parities, the court will try to reconcile the trust law rules with the trust deed provisions. While this ensures commercially sensible results are reached, the reasoning tends to be tenuous.

The central claims of this chapter are a general one and a specific one. The general claim is that, due to the unique nature of the trust property under bond trusts and security trusts, the nature of the legal relationships among the relevant parties in a bond trust or a security trust should be regarded purely as a multilateral contract. The essence of the contract is that the bondholders or the secured creditors provide funds to the issuer/borrower, the issuer/borrower undertakes to repay the money with interest, and the trustee undertakes to take actions on behalf of the bondholders including, in the case of a security trust, enforcing the security. This

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34 See for example *Concord Trust v Law Debenture Trust Corporation plc* [2005] UKHL 27.

35 *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* [1999] 1 NZLR 664 (CA) at 684.

36 See the cases referred to in n 2 above.

contractual relationship is recorded in the trust deed and the bond terms/loan agreements.[37] Each party's rights and obligations are determined in accordance with the terms of the contract and the factual matrix. Trust law principles and rules regarding express trusts, bearing the strong imprint of values historically derived from the family trust context, have no relevance.

The specific claim of this chapter is that, in a bond trust or security trust, the relationship between the trustee and the bondholders/secured creditors should be regarded as a type of collective agency created under contract. This proposition reflects the true commercial purposes of such structures: to allow the trustee to take actions on behalf of the bondholders/secured creditors.[38]

In relation to bond trusts, there exists a largely unnoticed yet critical aspect of the relationship between the bond trustee and the bondholders. This aspect provides a conclusive argument for the agency nature of this relationship. As mentioned earlier, the bonds are not part of the trust property; the full title belongs to the bondholders.[39] Nevertheless, under the bond trust deed, the trustee is entitled to take actions (such as negating or agreeing to the amendment of the bond terms) which will directly affect the rights of the bondholders in respect of the bonds. This power of the bond trustee can only be explained on the basis that the bond trustee is an agent of the bondholders.

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37 Usually the bond terms are printed on the back of the bond instrument. Bond terms refer to the bond trust deed and state that they are subject to the bond trust deed. Bond terms are also included in the bond trust deed as a schedule.

38 The similarity between a bond trustee and an agent has been pointed out by a number of English legal academics and practitioners. See for example Hudson, n 27 above, at [6.13]. Compare Tennekoon, n 12 above, at 227. As to security trustees, the term "security agent" and the term "security trustee" are often used interchangeably in the industry. See Jo Windsor and Paul Sidle "The Changing Role of the Security Agent in Restructurings" (15 July 2010) Linklaters <www.linklaters.com>.

39 See the text to n 28.

It is proposed that the issues in a bond trust or security trust be analysed purely in the contract law framework. Two cases, *Citibank NZ v MBIA Assurance SA* (the *Citibank* case)[40] and *Bank of New Zealand v New Zealand Guardian Trust Co Ltd* (the *BNZ* case),[41] are discussed below to illustrate why the contractual approach is preferable.

5.4.1 The *Citibank* case[42]

In 2001, Fixed-link Finance BV (FLF), a special purpose vehicle,[43] issued bonds to fund its purchase of certain debts in Eurotunnel. The bonds were "tranched" into senior bonds and junior bonds. If the payments received from Eurotunnel were not sufficient to cover FLF's payment obligations under both the senior bonds and the junior bonds, the senior bonds would be paid first. In addition, the senior bonds were guaranteed by MBIA Assurance SA (MBIA), whilst the junior bondholders had to rely solely on the creditworthiness of the Eurotunnel debt. Other than the bonds and the Eurotunnel debts, FLF had no substantial assets or liabilities.

Under the bond trust deed, all of FLF's rights in respect of the Eurotunnel debts (including its right to vote as a lender) were to be exercised by the bond trustee, Citibank NA (Citibank), in accordance with the instructions given by MBIA. It was further emphasised that, when acting in accordance with the instructions of MBIA, Citibank did not have to consider the interests of the bondholders.

In 2006, as part of the Eurotunnel debt restructuring, FLF was given the option to convert the Eurotunnel debts it held into cash of an amount equal to 61.9 per cent of the face value.

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40 [2006] EWHC 3215 (Ch).

41 [1999] 1 NZLR 213 (HC).

42 For discussion purposes, the facts of this case are simplified in this chapter.

43 In the context of securitization and structured finance, special purpose vehicles (SPVs) are legal entities set up purely for issuing debt securities and holding the underlying assets. Usually an SPV has no management or employee.

Given that MBIA was liable under its guarantee only for the senior bonds, it was no surprise that it instructed Citibank to exercise this option. QVT Financial LP (QVT), a junior bondholder, opposed this. Citibank sought directions from the court.

One of QVT's arguments was that Citibank, as a trustee, was subject to the irreducible core duty to act in good faith and to the benefit of beneficiaries. Therefore, MBIA's power to give instructions should be narrowly construed. This argument was rejected both in the High Court and in the Court of Appeal.[44] However, the two courts adopted different approaches.

In the High Court, Mann J held that, although various powers which were usually preserved to the trustee, were given to MBIA in the present case. That was done as a matter of commerce: "The Noteholders all take their commercial interests on terms that, and knowing that, MBIA wields the power that it wields."[45]

In the Court of Appeal, the issue of a trustee's core duty was considered by Lady Justice Arden.[46] Compared to Mann J, Arden LJ's reasoning struck a more conservative tone. Her Ladyship held that although various powers had been given to MBIA, the point where Citibank ceased to be a trustee had not been reached in the present case, because the trustee continued to have a duty of good faith and retained certain discretions under the bond trust deed, such as its discretion to give authorisations or waivers.[47]

With respect, Arden LJ's reasoning is not fully convincing. The core duty of a trustee is to perform the trusts "in good faith for the benefit of the beneficiaries."[48] Therefore, both the

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44 Other arguments of QVT did not succeed either.

45 [2006] EWHC 3215 (Ch) at [48].

46 Dyson LJ did not address the irreducible core duty argument. The Master of the Rolls did not give a separate judgment.

47 [2007] EWCA Civ 11 at [82].

48 *Armitage v Nurse*, above n 10, at 253, per Millett LJ.

"good faith" element and the "for the benefit" element are necessary components of the core duty. While it can be argued that Citibank was acting in good faith *vis-à-vis* the bondholders on the basis that following the instructions given by MBIA was something the bondholders had agreed to, it would appear difficult to argue that Citibank was acting for the benefit of the bondholders.

When MBIA gave instructions, it was acting purely in its own interest – to reduce its potential liability under the guarantee. This means that, when Citibank followed MBIA's instructions, Citibank was acting for the benefit of MBIA. Obviously, exercising the cash option would be detrimental to the interests of the junior bondholders. As to the senior bonds, because MBIA was the guarantor of these bonds, in most cases its instructions would also coincide with the interests of the senior bondholders. However, this is not necessarily always the case. This point can be illustrated by a hypothetical example. Let us assume that Eurotunnel offers to convert its debts into shares. Let us further assume that the trust deed expressly states that MBIA is entitled to direct Citibank to exercise this type of option, and if this happens, MBIA will cease to be liable under the guarantee. Obviously, the exercise of this option would be contrary to the senior bondholders' interests. However, as long as this is allowed under the bond trust deed terms, it should be upheld by the court. This outcome would certainly be undesirable to the senior bondholders. But that does not mean that equity would extend them a helping hand by prohibiting Citibank from following MBIA's instructions. The risk of MBIA being able to effectively terminate the guarantee by directing Citibank to exercise the option should have been reflected in the price of the senior bonds.

In addition, as observed by Trukhtanov,[49] the argument that Citibank retained sufficient discretion under the trust deed to be qualified as a trustee is not persuasive. The sweeping nature of the language used in the provisions regarding MBIA's powers strongly indicates that these

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[49] See above n 16, at 345.

powers are widespread and comprehensive, whereas Citibank's discretion has been reduced to miniscule levels. In fact, this reflects the commercial nature of the securitisation structure. MBIA, a party unrelated to Eurotunnel, would have been unlikely to agree to guarantee the bonds issued by FLF unless the documentation had provided it with almost absolute control over the Eurotunnel debts held by FLF.

Compared to Arden LJ, the reasoning of Mann J of the High Court is preferable. While not expressly spelt out, Mann J's judgment is almost equivalent to stating that the irreducible core duties are subject to the commercial terms which the parties have bargained for and agreed to. In essence, this approach puts more weight on the contractual nature of bond trusts over the trust nature of such structures.

It is debatable whether, in the context of "true" express trusts (i.e., the trust property having independent economic value), the parties should be allowed to exclude the fiduciary duty to act in good faith for the benefit of beneficiaries. However, in the context of bond trusts and security trusts where the trust property has no independent value, a strong case can be made that the core duty of a trustee may be contracted out. As discussed earlier, due to the trust property's unusual nature, a bond trust or security trust more closely resembles a contract, rather than a traditional trust.[50] Once the nature of the legal relationship between the bondholders and the bond trustee is properly viewed as a type of contractual agency, the decision of *Citibank* can be easily justified. It is true that the fiduciary duty of an agent to act in good faith for the benefit of its principal is a typical feature of the paradigm agency relationship. However, it is also well established that the scope of this duty may be limited, restricted, or even excluded by the relevant contractual provisions.[51] Applying a contractual approach to bond trusts will

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50 See the text to n 37.

51 See Peter Watts and Francis Reynolds (eds) *Bowstead and Reynolds on Agency* (20th ed, Sweet & Maxwell, London, 2014) at [6.037].

ensure that each party is held to its side of the bargain, including the exclusion of the duty to act for the benefit of the bondholders which would not be allowed under the trust law approach.

5.4.2 The *BNZ* case

In 1986, Commercial Securities Ltd ("Comsec") borrowed funds from four banks under a combined funding loan agreement. One of these banks was National Australia Bank (NAB).[52] To secure its obligations under the loans, Comsec issued the banks secured stock[53] for a total amount equal to 110 per cent of the loans. New Zealand Guardian Trust Co Ltd (Guardian) was appointed as the trustee. A charge over Comsec's assets was also granted to Guardian, which held the charge on trust for the banks. Under the covenant provisions of the trust deed, Comsec was not allowed to lend money to any subsidiary unless such a loan was secured to the satisfaction of the trustee. Guardian undertook to exercise reasonable diligence to ascertain whether any term of the trust deed was breached.[54]

In July 1987, the financial statements sent by Comsec to Guardian and the banks showed that it had lent approximately NZ$20 million to its subsidiaries. This ought to have alerted Guardian to the fact that there had been a breach of covenant, because the trustee knew that no approval had been sought or given in respect of the security arrangement for these subsidiary loans. In fact, no security was put in place for these loans at all.

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52 In 1993, all the assets of NAB, including its potential claim against Guardian, were transferred to Bank of New Zealand.

53 It appears that, while the term used in the case is "stock", the actual structure is more similar to a bond structure than to a stock structure under English law. The "stock" was issued by Comsec to each bank directly, and conferred each bank direct rights against the issuer. A parallel covenant to pay was given to the trustee under the trust deed.

54 In this regard, NZ law and practice differs from the position in the UK. In New Zealand, bond trustees are subject to an express duty of monitoring the performance of the issuer.

In July 1988, Guardian and the banks became aware of the existence of those unsecured subsidiary loans and the associated breach of issuer covenant. The banks waived the breach on certain conditions. In the following months, the financial position of Comsec deteriorated rapidly, and it was placed into receivership in Feb 1989. In the end, each bank recovered only approximately 10 percent of the sum due to them.

NAB brought proceedings against Guardian. Its claim was that the trustee was in breach of its duty to monitor, and that this breach caused NAB's loss: had the issuer's breach of covenant been detected, NAB would have been able to exit its loan to Comsec earlier and would thereby have avoided the loss. Evidence showed that in July 1987 NAB was actively looking for a way to exit the loan.

In the High Court judgment, Fisher J distinguished between two types of case with respect to the issue of causation. In the cases of the first category, a "close nexus" is required. To establish the causal link, the breach has to be a substantial cause, and the kind of loss reasonably foreseeable.[55] Further considerations include the proportion of the quantum of a risk to the actual amount of the loss, the degree of the defendant's culpability, the scope of the risk against which the defendant undertook to protect the plaintiff, the nature of the relationship and the reasonable expectations of the parties.[56] Breach of contract and tortious negligence fall into this category.[57] In the second category, a "distant nexus" would generally constitute sufficient causation. A distant nexus is established by applying a *but for* test. Cases involving breaches of trust causing loss to the trust estate, breaches of fiduciary duty and intentional torts, belong to the second category.

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55 See above n 23, at 241.

56 At 242–243.

57 It is possible to argue that, while a normal breach of contract belongs to the "close nexus" category, an intentional breach of contract should belong to the "distant nexus" category to deter intentional wrongdoings.

Fisher J held that the *but for* test was met in the present case. If Guardian had identified the covenant breach of Comsec and notified NAB, NAB could have threatened to enforce the security, in which case the three remaining banks would have bought out NAB's share.[58] However, the loss suffered by NAB was the loss of the early exit opportunity, a personal loss suffered under the loan. This loss was not a loss to the trust estate, because the chose in action to which the early exit related was not part of the trust estate.[59] Because of this, a distant nexus was not enough; a close nexus was required.[60] His Honour then held that in this case a close nexus had not been established, because the loss was not reasonably foreseeable,[61] and the trustee's breach was not a substantial cause.[62]

Fisher J's decision was unanimously upheld in the Court of Appeal. The joint judgment of Richardson P, Gault, Henry and Blanchard JJ was delivered by Gault J, while Tipping J delivered a brief concurring judgment.[63] While endorsing the view that a distant nexus was sufficient in cases of loss to trust property,[64] Gault J rejected Fisher J's finding that NAB could use Comsec's breach as a threat to early exit and could get full recovery. This is because, if the breach of covenant by Comsec were made known to Guardian and the banks, this breach would have been easily remedied by Comsec converting the subsidiary loans into equity, or providing satisfactory security to the subsidiary loans.[65]

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58 See above n 23, at 236.

59 At 251.

60 Fisher J also held that the duty to monitor was not a fiduciary duty. At 253.

61 At 254–255.

62 At 255.

63 [1999] 1 NZLR 664 (CA).

64 At 681.

65 At 674–678.

However, Gault J reasoned that there was a possibility that, if NAB had been notified of the breach, it would have tried to negotiate a voluntary withdrawal. This opportunity was not part of the trust estate.[66] In contrast to Fisher J's approach, which focused on casual potency, foreseeability and relative culpability, Gault J preferred the "scope of duty" approach adopted by Lord Hoffmann in *South Australia Asset Management Corporation v York Montague Ltd*,[67] and concluded that the scope and purpose of the duty to monitor, ascertained as a matter of construction from the documents and the overall context, did not cover the loss suffered by NAB.[68]

Very often, in terms of certain express trusts under which the trust property has an independent economic value, the legal relationship between the relevant parties is both contractual and in trust. Therefore, the trustee's liability, whether restitutionary or compensatory, can be addressed in a contractual law framework, or in a trust law framework. However, the results of the two approaches should converge. For example, in cases where an agent disburses a principal's funds in breach of instructions, the contractual approach dictates that the principal is entitled, as a matter of interpretation of the contractual terms, to claim a refund (a restitutionary remedy).[69] This remedy is independent of the compensatory remedies which the plaintiff may be entitled to. The same result is reached under the trust law approach on the basis of the beneficiary's right to require the trustee to restore the misapplied trust fund.[70] When the plaintiff is seeking a restitutionary remedy the issue of causation is irrelevant.

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66 At 679–680.

67 [1997] AC 191.

68 See above n 63, 684–685.

69 Peter Watts "Agent's Disbursal of Funds in Breach of Instructions" [2015] LMCLQ 118.

70 Steven Elliott "Compensation Claims against Trustees" (DPhil thesis, University of Oxford, 2002) at 54–62.

On the other hand, if the plaintiff is seeking a compensatory remedy, it becomes necessary to establish a causal link between the loss which the plaintiff is seeking to recover, and the defendant's breach. The answer to the question of whether a distant nexus is sufficient or whether a close nexus is required should be the same, whether the cause of action is at common law or in equity. In the context of traditional express trusts where the trust property has an independent economic value and the primary obligation of the trustee is to safeguard the trust property, a strong inference can be made that the trustee has agreed to be held liable for the loss as long as a distant nexus is proved. However, this proposition should operate as a mere presumption – perhaps a strong one in certain traditional trusts such as family trusts – but not as a universal rule.[71]

Unlike a typical express trust, the trust property under a bond trust has no independent value. As such, a restitutionary remedy should not be applicable – after all, the money is paid by the bondholders to the issuer directly. It would not be fair to allow the bondholders to seek a refund from the bond trustee which has not received the money in the first place. In addition, where the bondholders are seeking a compensatory remedy against the bond trustee, due to the illusory nature of the trust property under a bond trust, it would be difficult to draw any inference in favour of a distant nexus test based purely on whether a loss to the trust property has occurred.[72]

The fallacy of applying a trust law approach to bond trusts and security trusts is reflected in the difficulties of the reasoning of Fisher J. Addressing the issue of whether a loss to the trust property has occurred due to Guardian's breach, Fisher J drew a distinction between the right to enforce the security and the failure to enforce. The former is part of the trust estate; the latter

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71 For similar views, see Steven Elliott "Remoteness Criteria in Equity" [2002] 65(4) MLR 588 at 596.

72 It should be noted that these propositions will be equally applicable even if the bond trust is analysed under a contract law framework. This is because the bond trustee is not an "agent holding money for principal". See above n 51, at [6.041].

is not. As Fisher J reasoned, the right to enforce was not lost – Guardian had the right to enforce before and after its breach of duty to monitor. Accordingly, the trustee's breach did not cause any loss to the trust property.[73]

It is submitted that this argument is not convincing. The right to enforce and the failure to enforce are intrinsically linked to each other. In the *BNZ* case, the failure to exercise the right to enforce in July 1987 substantially diminished the value of the right to enforce. The right to enforce in July 1987, if exercised, could almost certainly have guaranteed a full recovery; the right to enforce in Feb 1989 led to a recovery rate of a mere 10 per cent. On this basis, the failure to exercise did result in a partial, if not total, loss of the value of the right to enforce.

In addition, adopting a trust law approach it is possible to argue that a loss to the trust estate had indeed occurred. Under the trust deed, Comsec granted Guardian a direct covenant to pay. Upon an event of default, this covenant to pay would be accelerated. Therefore, under the trust deed, Guardian had a right of early withdrawal through acceleration. Obviously such a right was held on trust.[74] It should be pointed out that while in practice the right of acceleration is mostly exercised only if the breach of the issuer indicates a worsening of the issuer's financial position, or other potential legal or credit risks, there is no legal restriction (at law or in equity) on the exercise of this right. The trustee is entitled to accelerate purely for opportunistic reasons. Either way, this right is held by the trustee as part of the trust property. This point can be illustrated by comparing a normal loan structure against a stock structure or bond structure under English law.

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73 See above n 23, at 251. This reasoning was concurred by Gault J in the Court of Appeal. See above n 63, at 680.

74 While the commercial intention is that such a covenant was meant to serve as a security for the chose in action under the loan facility (the amount of such a covenant being 110% of the loan amount), a strict legal interpretation of the terms of the trust deed would mean that, upon an event of default, the trustee would be entitled to demand Comsec to pay.

Under a typical loan agreement, there is little doubt that the lender is entitled to accelerate the loan upon an event of default, even if the default is purely technical in nature and does not indicate any financial weakness of the borrower. In other words, the lender is perfectly entitled to demand an early repayment, even if the demand is motivated purely by the lender's personal reasons.

Let us assume that, due to reasons not important for the current discussion, the borrower and the lender decide to structure the loan under a stock issue or bond issue instead of a loan facility. The terms regarding events of default in the trust deed are identical to those under the loan agreement. The trustee's right of acceleration under the trust deed, held on trust for the lender, is the equivalent of the right of the lender's right of acceleration under the loan agreement. This means that the trustee's right of early withdrawal includes early withdrawal for opportunistic reasons. In the *BNZ* case, this right was lost due to Guardian's breach.

Admittedly, the structure in *BNZ* is different from an English stock issue or a usual bond structure. In the *BNZ* case, notwithstanding the name "stock", the stock was actually issued to each bank, suggesting that it was more akin to a bond structure than to an English law stock issue. However, the stock was issued as a security for the loan extended by each bank to Comsec. This complex structure resulted in each bank having three choses in action: one under the loan agreement, one under the stock, and a beneficiary one under the trust deed.

The fact that there is an independent loan agreement suggests that, as between Comsec and the banks, the loan agreement is likely to be intended to be the key governing document, whereas the trust deed and the stock, providing security for the loan, are intended to be secondary. A breach of the trust deed terms by Comsec would simultaneously give rise to the banks' right of early withdrawal under the loan facility,[75] as well as an indirect right, through

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75 Each bank may also have a right of early withdrawal under the stock. However, from the facts of this case it is not clear what the terms of stock are.

the trustee, to demand immediate repayment. However, due to the way the documents were drafted in the *BNZ* case, these two rights are not exactly the same. The right to early exit under the loan agreement requires the approval of a majority of the banks,[76] whereas under the trust deed, each bank is entitled to demand that the trustee appoint a receiver, and an early exit.[77] In a sense, from NAB's perspective, the right to exit early through the trustee under the trust deed is more valuable than the right to exit under loan, because NAB is able to take individual action under the trust deed. The right of early withdrawal is part of the trust property. This right is lost due to Guardian's breach. This means, under a trust law approach, Guardian could be held liable for NAB's loss.

The truth of the matter is that bond trusts and security trusts are simply types of legal arrangements utilised by commercial parties where there are multiple lenders, and the lenders may intend to transfer the debts. A trust law approach, focusing on what is and what is not part of the trust property, is not helpful. Rather, the rights, duties and liabilities of each party should be determined by the presumed intention of the parties, objectively ascertained through the terms of the trust deed and the relevant context. Specifically, in relation to the issue of causation, the question to be asked should be: looking at the contractual terms and the relevant factors, do the parties intend that the trustee should be held liable for the particular loss caused by the particular breach? Of course, if the terms of the trust deed unequivocally indicate that the trustee is or is not liable for a particular type of loss, then that should be the end of the inquiry.[78] Most likely in practice, however, the trust deed is silent on this question. In such cases, the presumed intention of the parties will need to be determined by examining all relevant factors, such as

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76 See above n 63, at 675.

77 See above n 23, at 237.

78 Subject to the usual caveats in contract law, such as illegality and mistake etc.

foreseeability, the proportion of fees and the magnitude of potential loss of the relevant type, and the trustee's culpability.

This list of factors is very similar to the list suggested by Fisher J.[79] However, there is a crucial difference. As a matter of first principle under contract law, the parties' presumed intention must be determined as of the time when the contract was entered into. In particular, whether the loss is reasonably foreseeable to the trustee should be determined at the time of contract. The fact that the loss is foreseeable at a later time can be used as evidence to establish that the loss was also reasonably foreseeable at the time of contract, but nothing more. If an event occurring after the execution of the trust deed makes the loss reasonably foreseeable (for example, in the *BNZ* case, NAB advising Guardian that it was looking for a way to early exit), it should not change the scope of the trustee's liability unless the trust deed has been amended in this regard. This means that, even if NAB had advised Guardian of its desire to exit early from the facility, that would have no bearing on Guardian's liability.[80] The parties' duties and liabilities are set at the time of contract conclusion; they cannot be unilaterally changed afterwards.

A further point regarding foreseeability is that, while it is clearly an important factor, it is only one factor, and can be outweighed by other factors. Specifically, the fact that a loss is reasonably foreseeable does not necessarily mean the defendant is liable. For example, a taxi driver taking a client to the airport should reasonably foresee that, if the driver negligently chooses a congested route, the client might miss the flight, hence losing the value of the flight ticket. However, it seems very unlikely that the parties' presumed intention is that the driver should be held liable for this loss. In such a case, the foreseeability factor is outweighed by the proportion of the taxi fare to the quantity of the potential loss. Conversely, the fact that a loss

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[79] See text to n 56.

[80] Compare above n 23, at 254.

is not reasonably foreseeable does not necessarily mean the defendant is not liable. It is possible, at least in theory (but certainly unlikely in practice), that the parties' presumed intention is that the defendant is liable for any loss caused by its breach, even if the loss is not reasonably foreseeable. Obviously the price demanded by the defendant in such a case would be higher than other usual cases.

Applying the contractual approach to the *BNZ* case, there are a few factors in NAB's favour. Guardian is a professional trustee company and a trustee fee is paid to Guardian. Under the trust deed, Guardian has a duty to monitor the issuer's performance. In particular, the right to approve satisfactory security for subsidiary loans is given to the trustee under the trust deed; banks do not have an equivalent right under the loan facility. Therefore, a breach of this covenant by the issuer can be identified only by Guardian, not by the banks.

However, the factors in favour of Guardian seem stronger. Compared to the size of the potential loss, the fee paid the trustee is likely to be relatively small. Obviously the banks are sophisticated parties with experience and expertise at least equal to, if not more than, that of Guardian. Most importantly, the broader commercial background is that Guardian's appointment is mostly in relation to the security interest – both the security interest and the stock were to secure the bank loans. Therefore, the parties' presumed intention is likely to be that the Guardian's liability for failing to monitor is restricted to situations where there is a loss of the charged assets or the general assets of Comsec.

In terms of the particular breach of covenant in question, there is also evidence suggesting that the parties did not view the breach of covenant regarding subsidiary loans as a major problem. In fact, if this breach did occur, Comsec would be allowed to remedy the breach by converting the subsidiary loans into share capital without having to seek any consent from the banks or Guardian.[81] Furthermore, when the breach was finally apparent, the banks, including NAB, did not place too much importance on this. This further reinforces the view that, at the time of contract, the parities did not view Comsec' breach of covenant on subsidiary loans as a major issue. Therefore, it seems unlikely that the parties had intended that Guardian should be liable when Guardian's failure to identify Comsec's breach did cause any loss to the charges assets or the general assets of Comsec.

In fact, the covenant to provide security for subsidiary loans contained in the trust deed might just be a drafting error. Comsec claimed that their understanding had always been that they were entitled to provide loans to subsidiaries without having to provide security satisfactory to the trustee.[82] Indeed, a drafting error would also explain why the trust deed allows Comsec to convert subsidiary loans into share capital, rendering the covenant to provide security for subsidiary loans toothless.

5.4.3 Irrevocable authority

It has been argued that, for the bond structure to be effective, a valid trust in the conventional sense is vital.[83] If there were no trust, and the bond trustee were to be viewed as an agent of the bondholders, the general rule under agency law dictates that each bondholder would be entitled to revoke the authority.[84] As a result, certain commercial aspects of a bond trust structure, such as the ability of the trustee to take actions on behalf of the bondholders as a whole and the prohibition on each bondholder to sue the issuer directly, would be defeated.

First of all, it is arguable that any attempted revocation by an individual bondholder will not be effective *vis-à-vis* the issuer. The no-action clause is binding as a matter between the

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81 See above n 23, at 225,

82 See above n 23, at 228. The issue of rectification was not argued or further considered.

83 Tennekoon, above n 12, at 227–228.

84 See above n 51, at [10.024]; *Bailey v Angove's Pty Ltd* [2016] UKSC 47; [2016] 1 WLR 3179 at [6]–[10]; Peter Watts "The Insolvency of Agents" (2017) 133 LQR 11.

issuer and the bondholders. If an individual bondholder brings an action against the issuer, the no-action clause will provide a complete defence similar, in a way, to arbitration clauses.

However, revocation would be an issue in situations where the bond trustee enters into agreements with third parties, for example, a standstill agreement with other creditors of the issuer. If a bondholder were able to revoke the bond trustee's authority, it would bring serious disruption to the whole structure.

In fact, it is possible that, even under the orthodox view that there is a valid trust under the bond trust structure, the concern regarding the revocation of the trustee's authority already exists. For example, under the standard bond trust deed, the bond trustee, either on its own or at the direction of the majority of the bondholders, may agree with the issuer to change the terms of the bonds. Therefore, an individual bondholder may, relying on its title in the bonds, attempt to revoke the trustee's authority *in respect of the bonds*.

It is submitted that the bond trustee's authority, granted by the bondholders as a collective group, is revocable. As Francis Reynolds observed,[85] in situations where a principal revokes the authority in breach of its contract with other principals, damages are unlikely to be a satisfactory remedy. Therefore, the duties owed by one principal to the other principals should perhaps allow the specific performance remedy through treating the authority irrevocable.[86] While there seems to be no direct case law on this issue, an analogy can be drawn with the notion of fraud on other creditors in composition agreement cases.[87]

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85 Francis Reynolds "When is an Agent's Authority Irrevocable?" in Ross Cranston (ed) *Making Commercial Law* (Clarendon Press, Oxford, 1997) at 273–274.

86 For a similar proposition made in the context of intercreditor agreements, see Richard Hooley "Release Provisions in Intercreditor Agreements" (2012) 3 JBL 213 at 220–222.

87 Edwin Peel, *Treitel The Law of Contract* (London: Sweet & Maxwell, 13th ed, 2011) at [3.109].

5.5 Conclusion

The reasoning adopted by the courts in *Citibank* and *BNZ* reflects the tension between the orthodox concept of trust and the true nature of bond trusts and security trusts. While recognising the contractual nature of such trusts, the courts also applied the trust law principles and rules which are developed mostly in the context of traditional express trusts. That approach fails to adequately recognise the fundamental differences between the trust property of bonds trusts and security trusts and the trust property of traditional trusts. The trust property of traditional trusts has independent economic value; whereas the trust property of bond trusts and security trusts is supplementary in nature and has no independent economic value. Because of this, the contractual nature of these trust structures is paramount, and the rights and duties of each party should be analysed in a contract law framework. In particular, the legal relationship between the trustee and the bondholders/secured parities should be regarded as a collective agency. The authority of the agent cannot be revoked by an individual bondholder or secured party, but only in accordance with the terms of the trust deed.

It is envisaged that the terminology of “bond trust”, “security trust” and “trustees” alike, currently adopted by the current market practice, is likely to continue. However, the use of these terms should not cloud the true nature of the legal relationship involved in such structures. The relationship is contractual, not in trust. Recognising this nature will facilitate the process of determining the parties’ rights and duties. In the following two chapters, the contractual approach will be adopted to analyse the rights and obligations of the issuer and the bondholders in respect of the no-action clause and the exit consent technique respectively.

CHAPTER 6 NO-ACTION CLAUSE IN BOND TRUST

6.1 Introduction

Bond markets are an important source of finance. For example, as of March 2013, the total size of the United States bond market alone is US$39 trillion,[1] more than twice the size of the US equity market.[2] Most US dollar-denominated bonds are governed either by New York law or English law. Furthermore, due to the international nature of eurobonds[3] and the popularity of English law, English law is also the preferred governing law in the majority of eurobond issuances denominated in other currencies.

In terms of a eurobond issue, the relevant issuer needs to decide whether to appoint a trustee.[4] If it does decide to do so,[5] the issuer and the trustee will sign a trust deed, the terms

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1 Securities Industry and Financial Markets Association "US Bond Market Issuance and Outstanding – Annual, Quarterly or Monthly Issuance to January 2014 (Issuance) and from 1980 to Q3 2013 (Outstanding)" <www.sifma.org>.

2 The total size of the US stock market was around US$19 trillion in 2012. See World Bank Group *Market Capitalization of Listed Companies* <www.worldbank.org>.

3 A eurobond is a bond issued by a foreign issuer in a currency other than the currency of the country in which it is issued (for example USD bonds issued by a Japanese issuer in London). For an account of the history and development of the eurobond market, see Geoffrey Fuller *The Law and Practice of International Capital Markets* (2nd ed, LexisNexis, London 2009) at 105–124.

4 For discussions on the advantages and disadvantages of having a trustee for bond issues, see Philip R Wood *International Loans, Bonds, Guarantees, Legal Opinions* (2nd ed, Sweet & Maxwell, London, 2007) at 285–288; Financial Markets Law Committee (UK) *Trustee Exemption Clauses* (Issue 62, May 2004) at 16–17; Margery A Colloff "The Role of the Trustee in Mitigating Fraud in Structured Financings" (2005) 10(4) Journal of Structured Finance 73. The importance of bond trustee is also shown in insolvency cases where, the relevant bankrupt issuer not having appointed a trustee, the court appointed a trustee to act as the representative of all bondholders: see Kyong Lee and Karkus Heidinger "Bondholders in Insolvency Proceedings against an Austrian Issuer – the Maculan Case" (1998) 13 JIBL 118.

5 For sovereign bonds and bonds issued by major banks, the market practice is that no trustee will be appointed: see Philip R Wood *Law and Practice of International Finance* (Sweet & Maxwell, London, 2008) at 182.

of which are incorporated into the terms and conditions of the bonds. Generally speaking, under the trust deed, the issuer will provide a number of covenants, including a covenant to pay interest and principal,[6] to the trustee who holds such covenants on trust for the benefit of the bondholders. The trustee is given a wide range of powers, such as determining conclusively any question on the interpretation of the trust deed, calling a meeting of bondholders, and agreeing to certain modifications to the terms of the bonds, provided that the bondholders' interest will not be materially prejudiced by such modifications. Most importantly, once a default has occurred, the trustee may decide to accelerate the bonds and bring enforcement proceedings against the issuer.

Corporate bond issues governed by New York law almost invariably involve the appointment of a trustee for the bondholders. This is because, under the Trust Indenture Act of 1939 (US), appointment of a trustee through a trust indenture[7] is mandatory for public bond issues. For those bond issues to which the TIA does not apply, the market has adopted a similar structure. Broadly speaking, prior to default, the trustee is subject only to the duties and obligations specified in the trust indenture. After default, the trustee must protect the interests of the bondholders with the degree of care that a "prudent man" would take with respect to his own interests.[8]

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6 This covenant, together with other covenants given to the trustee for the benefit of bondholders, constitutes the trust assets: see Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 226. Under the terms of the eurobonds, the issuer also gives a parallel covenant to repay and to pay interest to each bondholder. Payments to bondholders will discharge the issuer's covenant to pay the trustee. By contrast, US trust indentures do not adopt this parallel covenant structure. It has been argued that they are not actual trusts because the trustee does not hold any assets on trusts for bondholders: Steven L Schwarcz "Commercial Trusts as Business Organizations: Unraveling the Mystery" (2003) The Business Lawyer 559 at 569. In the context of UK domestic stock issues, the covenant to repay and to pay interest is given only to the trustee: Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at 32.

7 The equivalent of English law governed bond trust deed.

8 TIA, s 315(c).

Under both English law governed eurobond trust deeds and New York law governed trust indentures, there is a so-called "no-action" clause which prohibits individual bondholders from taking enforcement actions unless the trustee, having become obliged to do so, fails to proceed.[9] This provision is crucial for bond trust structures, the primary purpose of which is to centralise enforcement actions. Without the no-action clause, bondholders can simply bypass the trustee and take actions themselves. Traditionally, bondholders are comfortable with the trustee being in control of enforcement actions. However, when the number of bond defaults increases during a financial crisis, it is inevitable that some bondholders may become dissatisfied with the trustee's actions (or inactions). Furthermore, hedge fund investors tend to read and enforce bond provisions aggressively as part of their overall investment strategies. As a result, there are more cases in which the no-action clause is challenged.

This chapter first sets out typical no-action clauses and explains their purposes. It then examines the two different approaches to the construction of no-action clauses and discusses whether pre-default claims and individual claims are covered by such clauses. This chapter concludes with objections to no-action clauses.

6.2 No-action clauses

The wording of a typical no-action clause in eurobonds is as follows:[10]

> (1) The Trustee may at any time, at its discretion and without notice, take such proceedings against the Issuer and/or the Guarantor as it may think fit to enforce the terms of the Trust Deed, the Notes[11] and the Coupons, but it need not take any such

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9 Similar clauses are also seen in other financial products documents, such as the servicing agreements in securitisation.

10 This clause is drafted on the assumption that the bonds are guaranteed.

11 There is no real difference between notes and bonds. Fixed rate securities tend to be referred to as "bonds", and floating rate securities and structured products are normally called "notes". See Fuller, above n 6, at 35. They are used interchangeably in this chapter.

> proceedings or any other action in relation to the Trust Deed, the Notes or the Coupons unless:
>
> (a) it has been directed to do so by an Extraordinary Resolution of the Noteholders or requested to do so in writing by the holders of at least one-fifth in principal amount of the Notes then outstanding; and
>
> (b) it has been indemnified to its satisfaction.
>
> (2) No Noteholder or Couponholder may proceed directly against the Issuer or the Guarantor unless the Trustee, having become bound so to proceed, fails to do so within a reasonable period and the failure is continuing.[12]

No-action clauses in US trust indentures are more complex. The provisions of a typical US no-action clause are as follows:[13]

> A Security holder may pursue a remedy with respect to this Indenture or the Securities only if:
>
> (1) the Holder gives to the Trustee notice of a continuing Event of Default;[14]
>
> (2) the Holders of at least 25 per cent in principal amount of the Securities make a request to the Trustee to pursue the remedy;
>
> (3) such Holder or Holders offer to the Trustee indemnity satisfactory to the Trustee against any loss, liability or expense;
>
> (4) the Trustee does not comply with the request within 60 days after the receipt of the request and the offer of indemnity; and

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12 Fuller, above n 6, at 148.

13 There are other varieties of this clause in use. See for example *Savient Pharmaceuticals Inc v Tang Capital Partners* WL 3072347 (Del Ch 2012), where the no-action clause in the relevant trust indenture provided that: "no Holder of any Note shall have any right by virtue of or by availing of any provision of this Indenture to institute any suit, action or proceeding in equity or at law upon or under or with respect to this Indenture, or for the appointment of a receiver, trustee, liquidator, custodian or other similar official, or for any other remedy hereunder, unless certain requirements are met."

14 Default includes failure to pay, breaches of other terms which last for 30 days, and bankruptcy events.

> (5) during such 60-day period the Holders of a majority in principal amount of the Securities do not give the Trustee a direction inconsistent with the request.
>
> A Security holder may not use this Indenture to prejudice the rights of another Security holder or to obtain a preference or priority over another Security holder.[15]

The US no-action clause is subject to certain contractual exceptions:[16]

> Notwithstanding any other provision of this Indenture, the right of any Holder of a Security to receive payment of principal and interest on the Security, on or after the respective due dates expressed in the Security, or to bring suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of the Holder.[17]
>
> Notwithstanding any other provision of this Indenture, the right of any Holder of a Security to bring suit for the enforcement of the right to convert the Security shall not be impaired or affected without the consent of the Holder.[18]

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[15] American Bar Association, Committee on Developments in Business Financing "Model Simplified Indenture" (1983) 38 The Business Lawyer 741 at 757 (s 6.06).

[16] Model Modified Indenture, s 6.07.

[17] This exception is required by the TIA. Section 316(b) provides that "the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective dates, shall not be impaired or affected without the consent of such holder". The reason for the exception is that "[n]o such justification [for restrictions on bondholders' right to sue] exists where a bondholder seeks merely to collect the interest or principal due and owing him under the bond": *Watts v Missouri-Kansas-Texas Railroad Co* 383 F 2d 571 (5th Cir 1967) at 574. It has been suggested that there is no such exception under English law: Tennekoon, above n 6, at 212. But see [6.3.1] of this thesis.

[18] In the *Revised Model Simplified Indenture* published in 2000, there is a third exception: "Nothing in this Indenture limits or defers the right or ability of Holders to petition for commencement of a case under applicable Bankruptcy Law to the extent consistent with such Bankruptcy Law." This is added to address the concerns caused by cases such as *Re Iroquois Brands Inc* (Bankr SD Tex, No 91–01018–H3–11, 7 March 1991). Those cases held that bondholders were not entitled to act as a petitioning creditor in an involuntary bankruptcy: American Bar Association, Ad Hoc Committee for Revision of the 1983 Model Simplified Indenture "Revised Model Simplified Indenture" (2000) 55 The Business Lawyer 1115 at 1193.

No-action clauses serve multiple purposes.[19] One of the basic premises underlying bond trust structures is that all bondholders are treated as one single class. They share all payments under the bonds on a pro rata basis.[20] No-action clauses help to ensure that this is achieved by preventing the "race to the courthouse door".

Secondly, where the issuer is in financial difficulties, it might be in the best interests of bondholders as a whole to abstain from taking enforcement actions against the issuer. There are also cases where a technical breach has occurred, but any sensible bondholder would not accelerate the bonds based solely on such a breach. In these cases, one bondholder's action could make the situation worse and even push the issuer into bankruptcy.[21] As Chancellor Allen observed:

> [No-action clauses] protect against the exercise of poor judgment by a single bondholder or a small group of bondholders, who might otherwise bring a suit against the issuer that most bondholders would consider not to be in their collective economic interest.[22]

Thirdly, no-action clauses avoid multiplicity of lawsuits. Each bondholder's rights are based on the same set of documents: the trust instrument and the bond terms. In the interests of the issuer, the bondholders and the general public, enforcement of the documents and the remedies should be dealt with in one suit brought by the trustee.

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19 See for example Marcel Kahan "Rethinking Corporate Bonds: The Trade-off Between Individual and Collective Rights" (2002) 77 NYULR 1040 at 1053–1057.

20 Pro rata sharing clauses are also seen in syndicated loan agreements. But usually such agreements do not contain no-action clauses: Wood, above n 4, at 127–128.

21 This is called the "mad bondholder" problem. See for example Anthony Herbert "Why Have a Trustee for a Eurobond Issue?" (1987) 2 JIBL 48 at 49. Dome Petroleum is an often cited example of this problem. Dome was in financial difficulties and negotiated waivers from creditors. The waivers were subject to the condition that no enforcement proceedings would be brought against Dome. However, one bondholder insisted on being paid and brought proceedings. See Josephine Carr "One Lesson to be Learnt from Dome Petroleum" (1987) 6 IFLR 15.

22 *Feldbaum v McCrory Corp* 18 Del J Corp L 630 (Del Ch 1992) at 633, 642.

It has been said that no-action clauses offer protection to issuers against frivolous litigation.[23] However, the concern may be exaggerated.[24] In today's financial markets, most bond investors are institutions. Such investors have access to proper legal advice, and should be able to find out whether a particular lawsuit has merit.[25]

6.3 Scope and efficacy of the no-action clause

The validity of no-action clauses has long been upheld by the UK and US courts. The key justification given by the courts is that bondholders have freely consented to such clauses by investing in the bonds.[26] Investors are given the opportunity to participate in collective lending to the issuer, which they would not be able to do on an individual basis. In return, investors agree to restrict their individual rights to seek remedies unless the conditions in the no-action clause are met.[27]

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23 See for example *Feldbaum v McCrory Corp* 18 Del J Corp L 630 (Del Ch 1992) at 642.

24 See Kahan, above n 19, at 1061.

25 It is worth pointing out that, in terms of bonds issued by financial institutions without a trustee, they do not contain a no-action clause. Yet, in the absence of default, cases initiated by bondholders against such issuers seem rare.

26 But see Martin Riger "The Trust Indenture as Bargained Contract: The Persistence of Myth" (1991) 16 J Corp L 211.

27 Where the clause is not brought to the attention of bondholders, the courts may strike it down. See for example Wood, above n 4, at 296; Tennekoon, above n 6, at 210. The common practice is that the no-action clause is disclosed in the bond terms: *Revised Model Simplified Indenture*, above n 18, at 1192. Thus it is not open for bondholders to claim that they have not consented to this clause. Whether bondholders have in fact read the clause before purchasing the bonds is irrelevant. By way of background, investors are rarely involved in documentation negotiation. Bond terms and trust instruments are negotiated among the issuer, the trustee and the underwriter. Technically speaking, the underwriter is not a party to the trust instrument. However, they do provide comments on the documents. This is understandable, given that they are responsible for selling the bonds to investors. In practice, underwriters tend to comment only on commercial terms of the bonds and do not review closely the legal terms (such as the no-action clause) unless they deviate from market standard. It is worth pointing out that, in the context of sovereign bonds, studies based on empirical evidence show that impact on pricing from inclusion of collective action clauses is small:

The argument that no-action clauses are invalid because they deprive bondholders of their common law right to sue as creditors has been rejected by the courts. As Jacob J explained, if public policy in favour of the common law right to sue overrode no-action clauses:

> It would mean that English companies could not readily issue bonds with no-action clauses – whatever the terms of the bond, and whether pre- or post default, they would be exposed to the potentiality of a single bondholder bringing an administration petition. It is not self-apparent why that should be so.[28]

While the no-action clause is valid and enforceable in general, there are uncertainties about its scope and efficacy in some situations. First, there are different views as to whether no-action clauses cover extra-contractual (ie non-contractual) claims. Secondly, in the context of the US no-action clause, there are debates as to whether pre-default claims are barred. Thirdly, in some cases, where a claim is a class claim (which is barred by the no-action clause) or an individual claim (which is not barred) may seem unclear. These issues are discussed below.

6.3.1 The expansive approach

The wording of standard no-action clauses does not expressly state whether only claims based on contractual terms are barred, or both contractual and extra-contractual claims are prohibited. One approach is to construe no-action clauses broadly to cover both contractual claims under the trust instruments and extra-contractual claims (such as tortious claims), as

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Torbjörn Becker, Anthony Richards and Yunyong Thaicharoen "Bond Restructuring and Moral Hazard: Are Collective Action Clauses Costly?" (2003) 61 Journal of International Economics 127.

28 *Re Colt Telecom Group plc* [2002] EWHC 2815 (Ch) at [62] per Jacob J. See also *Savient Pharmaceuticals Inc v Tang Capital Partners* WL 3072347 (Del Ch 2012) at 20–23. It is worth noting that restrictions on the right to sue in other contexts, such as arbitration clauses in contracts and no-action clauses in insurance policies, have generally been held valid and enforceable.

long as the relevant claim is shared by all bondholders.[29] Such a construction is consistent with the function of the no-action clause, namely centralisation of enforcement actions. It will also prevent "cause of action shopping". In other words:

> [N]o matter what legal theory a plaintiff advances, if the trustee is capable of satisfying its obligations, then any claim that can be enforced by the trustee on behalf of all bonds ... is subject to the terms of a no-action clause.[30]

In two recent cases, the English courts adopted the expansive approach. In *Re Colt Telecom Group plc*,[31] the plaintiff purchased notes issued by Colt Telecom. The notes were governed by New York law, and the no-action clause in question was a US no-action clause. The plaintiff applied for an administration order under s 9 of the Insolvency Act 1986 (UK), claiming that Colt Telecom was likely to become insolvent. Colt Telecom argued that the application for an administration order was barred by the no-action clause because it was "pursuit of any remedy with respect to the Indenture or the Notes". The plaintiff, relying on expert evidence of New York law provided by Professor Kahan, countered that the clause ought to apply only to contractual claims. Jacob J did not agree: "I can see no rational purpose in limiting the bar to 'contractual claims'. If it were so limited then individuals could undermine the policy by applying for a receiver or the sort of action taken in this case."[32]

In *Elektrim SA v Vivendi Holdings 1 Corp*,[33] the English Court of Appeal was asked to consider the effect of the eurobond no-action clause. The background of this case was a long battle between Elektrim and Vivendi over who should have the ownership of certain shares in

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29 See for example Philip Rawlings "Reinforcing Collectivity: The Liability of Trustees and the Power of Investors in Finance Transactions" (2009) 23 *Tru L I* 14 at 19.

30 *Feldbaum v McCrory Corp* 18 Del J Corp L 630 (Del Ch 1992) at 643.

31 [2002] EWHC 2815.

32 *Re Colt Telecom Group plc* [2002] EWHC 2815 (Ch) at [56], per Jacob J.

33 [2008] EWCA Civ 1178.

a Polish telecommunications company. The shares had been sold by Elektrim and part of the proceeds was paid to the trustee to satisfy Elektrim's obligations as issuer under the relevant bonds. As part of its efforts to prevent the trustee from distributing the funds to the bondholders, Vivendi purchased eight per cent of the bonds through one of its subsidiaries, and sued Elektrim and the trustee in Miami, claiming, among other matters, that the funds paid by Elektrim to the trustee were "tainted" due to Vivendi's own claim over the shares. These claims were stated to be claims in tort. Elektrim applied to the English court for an anti-suit injunction to prohibit Vivendi from continuing its action in Miami. Vivendi argued that its tortious action in Miami was not barred by the no-action clause. This was rejected both in the High Court and in the Court of Appeal. Collins LJ said:

> [T]he purpose of the normal bond issue Trust Deed is that bondholders should act through the Trustee, and share equally in the fortunes of the investment, and not compete with each other. The bondholders are treated as forming a class, and give instructions to the Trustee through a specified percentage of bondholders. Such a scheme promotes liquidity. The no-action should be construed, to the extent reasonably possible, as an effective bar to individual bondholders pursuing, for their own account, what are in substance class claims. That can apply to tortious claims as well as to contractual claims.[34]

The expansive approach has also found favour with US judges in a number of cases, such as *Peak Partners LP v Republic Bank*.[35] The notes involved in this case were mortgage-backed securities. Under the sales and servicing agreement between, among others, US Bank (trustee) and Republic Bank (servicer), Republic Bank provided to the trustee monthly servicer certificates. The trustee made monthly distributions to the noteholders, relying on the numbers in the servicer certificates. However, the numbers were incorrect as they did not take into account the servicing fees Republic Bank was deducting each month. The trustee made

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[34] *Elektrim SA v Vivendi Holdings 1 Corp* [2008] EWCA Civ 1178 at [101], per Collins LJ.

[35] 191 Fed Appx 118 (3rd Cir 2006).

overpayments of US$10 million to the noteholders over a period of 19 months, resulting in the over-collateralisation amount being reduced by US$10 million. Upon finding this error, the trustee notified the noteholders that it would offset overpayments against payments due in the following three months.

The plaintiff was a holder of the notes. It brought proceedings against the Republic Bank for negligence. Prior to initiating the proceedings, it had sold the notes at a profit. Its claim was, but for the servicer's error, its profit would be more than US$700,000. The plaintiff argued that the no-action clause did not bar its action because the Republic Bank was not a party to the trust indenture. As such, its suit against the Republic Bank was not "with respect to this Indenture" and it was not seeking any "remedy" under the terms of the Indenture.[36]

The court held that the action was barred by the no-action clause because all bondholders were equally affected by the defendant's alleged negligence. Barry J commented that the no-action clause "only forces individual bondholders to channel their grievances through the Indenture Trustee in accord with the policy underlying the inclusion of no-action clauses in Indenture agreements",[37] and "US Bank, had it been asked by the bondholders in accordance with the no-action clause, could have asserted tort claims against Republic [Bank] for erring in the Servicer Certificates".[38]

The expansive approach was again adopted by the US court in a recent case, *Akanthos Capital Management v CompuCredit Holdings Corp*.[39] In this case, the plaintiff, who held a majority of the bonds issued by the defendant, claimed that a dividend paid by the defendant to its shareholders constituted a fraudulent transfer under Georgia's version of the Uniform

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36 *Peak Partners LP v Republic Bank* 191 Fed Appx 118 at 126 (3rd Cir 2006), per Barry J.

37 *Peak Partners LP v Republic Bank* 191 Fed Appx 118 at 127 (3rd Cir 2006), per Barry J.

38 *Peak Partners LP v Republic Bank* 191 Fed Appx 118 at 127 (3rd Cir 2006), per Barry J.

39 677 F3d 1286 (11th Cir 2012).

Fraudulent Transfer Act. Relying on three earlier cases,[40] the court found that, as a general rule, no-action clauses barred fraudulent conveyance claims, and there was "no persuasive reason to deviate from that rule in the present case."[41]

6.3.2 The restrictive approach

The expansive construction of the no-action clause has not been accepted universally. It has been argued that, in accordance with the doctrine of contra proferentem,[42] the courts should adopt a restrictive approach, namely that no-action clauses cover only contractual claims,[43] not claims under other laws (including securities law).[44]

The restrictive approach is contrary to the purposes of the collective action mechanism in the bond trust structure. Bondholders may try to conduct "cause of action shopping", even though various causes of action are all based on the same set of facts. In terms of the US no-action clause, adopting this narrow view would lead to the conclusion that any action against a third party is to be barred, since obviously there is no contractual relationship between bondholders and the third party. Yet the US courts have held that no-action clauses cover suits against third parties.[45]

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40 *Feldbaum v McCrory Corp* 18 Del J Corp L 630 (Del Ch 1992); *Lange v Citibank, NA* WL 2005728 (Del Ch 2002); *Ernst v Film Production Corp* 148 Misc 62 (NY Sup Ct 1933). In all three cases, similar arguments were rejected.

41 *Akanthos Capital Management v CompuCredit Holdings Corp* 677 F3d 1286 (11th Cir 2012) at 1295. This approach has also been adopted in a Canadian case: *Casurina Ltd Partnership v Rio Algom Ltd* (2004) 40 BLR (3d) 112.

42 "If any such restriction is uncertain, obscure or ambiguous, then any such doubt or uncertainty will be resolved against the maker of the bond and in favour of the bearer thereof": *Perry v Darlington Fireproofing Co* 76 Ohio App 101 (Ohio App 1945) at 108.

43 See for example Kahan, above n 19, at 1082.

44 Revised Model Simplified Indenture, above n 18, at 1191.

45 See for example *McMahan v Wherehouse Entertainment Inc* 65 F3d 1044 (2nd Cir 1995); *Feldbaum v McCrory Corp* 18 Del J Corp L 630 (Del Ch 1992).

In practice, the restrictive approach has received limited judicial support, if any. A number of cases, such as *Kusner v First Pennsylvania Corp*,[46] *Envirodnye Industries Inc v Connecticut Mutual Life Co*,[47] *Acacia National Life Insurance Co v Kay Jewelers Inc*,[48] and *McMahan v Wherehouse Entertainment Inc*,[49] have been cited as authority supporting the restrictive construction of the no-action clause.[50] In each of these cases, it was held that the plaintiff's claims under statutes were not barred by the no-action clause. However, a closer look reveals that the decisions in these cases are, or can be, justified on the ground that the non-application of the no-action clause to those claims is due to the anti-waiver provisions in the relevant statutes.[51] In contrast, there is a line of cases holding that fraudulent transfer claims, which are based on statues, are barred by no-action clauses.[52] Those cases indicate that there is no general rule that all claims based on other laws are barred; but where the relevant statutes

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46 531 F2d 1234 (3rd Cir 1976).

47 174 BR 986 (Bankr ND Ill 1994).

48 610 NYS2d 209 (NY Sup Ct 1994).

49 65 F3d 1044 (2nd Cir 1995).

50 *Revised Model Simplified Indenture*, above n 18, at 1191; James Gadsden "Indenture 'No-Action' Clauses Bar Independent Claims by Securityholders" (2013) BLJ 226 at 230.

51 *Kusner v First Pennsylvania Corp* 31 F2d 1234 (3rd Cir 1976); *Acacia National Life Insurance Co v Kay Jewelers Inc* 610 NYS2d 209 (NY Sup Ct 1994) and *McMahan v Wherehouse Entertainment Inc* 65 F3d 1044 (2nd Cir 1995) involve claims under the Securities Act of 1933 (US) and the Securities Exchange Act of 1934 (US). Both Acts contain anti-waiver provisions which provide that any provision binding any person to waive compliance with the Acts shall be void. See *McMahan v Wherehouse Entertainment Inc* 65 F3d 1044 (2nd Cir 1995) at 1051. In *Envirodnye Industries Inc v Connecticut Mutual Life Co* 174 BR 986 (Bankr ND Ill 1994), the bondholders were allowed to petition for involuntary bankruptcy because the interest payments on the bonds were already overdue. As mentioned earlier, the TIA makes the bondholder's right to recover overdue interest and principal absolute. See also *Upic v Kinder-Care Learning Centers Inc* 93 F Supp 448 (SD NY 1992).

52 See above nn 40–41 and the accompanying text.

do not contain anti-waiver provisions, claims under those statutes are covered by no-action clauses.[53]

6.3.3 Pre-default claims

Under the US no-action clause, bondholders are required, among other things, to serve a notice of event of default on the trustee before pursuing any remedy directly against the issuer.[54] There are two possible interpretations regarding this requirement. One is that bondholders are not prevented by the no-action clause from taking actions prior to default, because it is just not possible for them to comply with this requirement. This interpretation seems plainly illogical – how can bondholders be allowed to sue when there is no event of default, but prohibited from suing when there is a default?[55]

The other (more likely) possibility is that bondholders are not entitled to pursue suits prior to default. But this leads to another question: does the trustee have authority to take actions prior to default? If the trustee does not have the authority, it would mean that bondholders under US trust indentures have waived their rights to pursue remedies in cases where no event of

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[53] It would appear that the restrictive approach has also been adopted in *Metropolitan West Asset Management v Magnus Funding* WL 1444868 (SD NY 2004) at 5. Buchwald J said: "Where, as here, a 'no action' provision applies by its terms to only claims relating to an 'Event of Default' seeking payment on the notes themselves, such clauses do not prevent noteholders from bringing extra-contractual tort claims or breach of contract claims that are not of the type to which the 'no action' provision, by its terms, applies." This statement was cited with approval in *Howe v Bank of New York Mellon* 783 F Supp2d 466 (SD NY 2011) at 473. However, it is submitted that the decisions in these two cases that the bondholder's claims were not barred by the no-action clause are better explained on the ground that, in both cases, the trustee's misconduct had been alleged. In fact, the trustee was a co-defendant in both cases. It is long established that no-action clauses do not apply where a trustee's misconduct or conflict of interest was involved. See for example *Akanthos Capital Management v CompuCredit Holdings Corp* 677 F3d 1286 (11th Cir 2012); *CFIP Master Fund Ltd v Citibank NA* 738 F Supp2d 450 (SD NY 2010).

[54] The eurobond no-action clause does not contain such a condition. Therefore, pre-default claims are clearly covered.

[55] *Re Colt Telecom Group plc* [2002] EWHC 2815 at [56], per Jacob J.

default has occurred. As Professor Kahan pointed out, the "underlying premise of subjecting claims to the no-action clause – and thus of relegating their enforcement to bondholders collectively and to the trustee as their representative – is that collective enforcement of the claims is at least theoretically possible".[56] Therefore, it is difficult to see why bondholders would agree to waive their rights to pursue remedies in cases where a default has not occurred. In fact, if the parties to the trust indenture do intend that the bondholders' rights of action prior to default are to be waived, it would be reasonable to expect that such terms are expressly stated in the trust indenture.[57]

Of course, there will be no waiver of rights by bondholders if the trustee does have the power to take actions on behalf of the bondholders prior to default. Under the standard enforcement provision in the *Model Modified Indenture* "[i]f an Event of Default occurs and is continuing, the Trustee may pursue any available remedy to collect the payment of principal or interest on the Securities or to enforce the performance of any provisions of the Securities or this Indenture".[58] The wording of this provision seems to suggest that the trustee's powers are limited to those necessary to enforce the performance of the bonds or the trust indenture after a default has occurred. This interpretation has been adopted by the courts in some cases, such as *National City Bank v Coopers & Lybrand*,[59] *United Bank of Arizona v Sun Mesa Corp*,[60] and *Central Bank of Denver v Deloitte & Touche*.[61] However, it is important to note that, in those cases, the courts adopted the restrictive approach to the interpretation of the no-action clause, holding that, while the trustee had no standing, the bondholders were entitled to bring

56 Kahan, above n 19, at 1072.

57 Kahan, above n 19, at 1070–1077.

58 Model Modified Indenture, s 6.03.

59 409 NW 2d 862 (Minn CA 1987).

60 119 FRD 430 (D Ariz 1988).

61 928 P2d 754 (Co CA 1996).

proceedings themselves. There seems to be no case in which neither the trustee nor the bondholders are granted standing to sue.[62]

6.3.4 Individual claims

It is well established that no-action clauses only bar claims which are shared by all bondholders as a class. As Chancellor Allen explained:

> In consenting to no-action clauses by purchasing bonds, plaintiffs waive their rights to bring claims that are common to all bondholders, and thus can be prosecuted by the trustee, unless they first comply with the procedures set forth in the clause or their claims are for the payment of past-due amounts.[63]

The corollary of the above rule is that individual claims are not barred by the no-action clause. It would not be appropriate for the trustee to pursue a remedy based on claims not shared by all bondholders, because the trustee is the representative of all the bondholders, not a subset of bondholders. The situations in which individual claims may arise can be broadly divided into two categories.

Differentiated treatment by issuer

The cases falling under this category are relatively straightforward. If the issuer treats one bondholder differently from other bondholders, any claim of this bondholder based on the differentiated treatment will be an individual claim. One obvious example is where the issuer fails to make a payment to a bondholder.[64] Another example is where the issuer has made a

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62 See also *Elliott International LP v Law Debenture Trustees Ltd* [2006] EWHC 3063 (Ch) at [54]. In that case, the English High Court declared that the trustee had no power to commence opposition proceedings before a French court to challenge French insolvency proceedings, but the bondholders were not barred by the no-action clause to bring such proceedings.

63 *Feldbaum v McCrory Corp* 18 Del J Corp L 630 (Del Ch 1992) at 644.

64 Most bonds are issued in global form today. As such, it would be practically impossible for the issuer to make payments to some bondholders, but not to other bondholders. However, such a scenario may arise where bonds are issued in definitive form.

misrepresentation to a particular bondholder.[65] If the issuer makes a private exchange offer to some bondholders, other bondholders' claims are also individual and will not be barred by the no-action clause.[66]

Distinguishing factor

Individual claims may arise where, notwithstanding that all bondholders are treated in the same way by the issuer, one bondholder is affected in a way different from other bondholders due to a distinguishing factor (other than the percentage of its holding). In such cases, either the nature of the claim or the amount of loss (or both) of the bondholder will be different from those of other bondholders. Therefore, such claims should not be channeled through the trustee.

The distinguishing factor may be that the terms of some bonds are different from other bonds, or the relevant bondholder has chosen a course of action different from other bondholders.

Cypress Associates LLC v Sunnyside Cogeneration Association Project is an example of the former case.[67] Carbon County issued Series A and Series B bonds in 1987. Sunnyside had succeeded the issuer's rights and obligations under the bonds. The Series A bonds had fixed interest payable semiannually. The Series B bonds did not have any guaranteed interest. Instead, Series B bondholders were entitled to annual payments of a part of Sunnyside's profit. Under the relevant documents, Sunnyside was not allowed to amend a power purchase agreement with

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65 See Rawlings, above n 29, at 22. As explained by Davidson J in *Central Bank of Denver v Deloitte & Touche* 928 P2d 754 (Co CA 1996) at 758: "An 'equal and ratable' distribution of a tort award would be reasonable if intended to pay principal, premium, and interest since all bonds are of equal stature. However, an 'equal and ratable distribution' would not be consistent with the interests of persons injured in tort, if, as here, injury would vary from plaintiff to plaintiff depending on if and when each bondholder relied on defendant's audit information."

66 See for example *Whitebox Convertible Arbitrage Partners LP v World Airways Inc* WL 358270 (ND GA 2006).

67 WL 668441 (Del Ch 2006).

Utah Power & Light Co unless 80 per cent of bondholders had given consent. Sunnyside intended to amend this agreement and sought consent from the bondholders. The amendment, if implemented, would reduce Sunnyside's profit. The plaintiff held Series B bonds, which constituted more than 20 per cent of the total amounts of the Series A and Series B bonds. It refused to give consent, because the amendment would substantially reduce the annual payments to the plaintiff as a Series B bondholder. After obtaining consent from all other bondholders, Sunnyside proceeded with amending the power purchase agreement. The plaintiff brought proceedings against Sunnyside. The court held that the plaintiff's action was not barred by the no-action clause, because such a clause, being "designed to limit suits on behalf of all holders unless a majority supports the suits", was not meant to cover claims arising under provisions which gave 20 per cent minority bondholders the right to block an amendment.[68]

A recent decision, *Emmet v Catholic Health East*,[69] provides an example where the relevant bondholder has chosen a course of action different from other bondholders. Catholic Health, which had succeeded to the rights and obligations of the original issuer, offered to purchase bonds at a price of 101 per cent and would redeem at par all other bonds which were not tendered. The trust indenture provided that Catholic Health was entitled to redeem the bonds early, but any such redemption had to be done by lot. The plaintiff, Emmet, preferred to keep the bonds as the coupon rate was higher than the market interest rate. It claimed that the early redemption of the bonds not tendered contravened the early redemption provision, because the bonds purchased by Catholic Health in the tender offer would remain outstanding. The court held that the plaintiff's claim was barred by the no-action clause.[70] It is questionable whether

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68 Recognising bondholders' right to sue in such cases would resolve the apparent contradiction between bondholder's individual rights to consent to amendment of certain terms and the collective enforcement mechanism in bond trust structures. But see Kahan, above n 19, at 1074–1076.

69 37 Misc3d 854 (NY Sup Ct 2012).

70 Relying on earlier authorities, the court rejected the plaintiff's argument that the no-action clause should not apply in one sentence: "[A]ccording to the courts of this state, a party cannot sue to assert its rights

this conclusion was correct. Emmet's claim was an individual claim, because Emmet distinguished itself from those bondholders who willingly tendered their bonds to Catholic Health. Emmet was entitled to assert against Catholic Health that there was a breach of the early redemption provision – the breach indeed occurred is a separate issue.[71] This assertion was not open to the bondholders who had sold their bonds to Catholic Health. Hence, the trustee was not the right person to sue on behalf of Emmet, and Emmet's claim should not have been barred by the no-action clause.

6.4 Objections to the no-action clause

The no-action clause has been subjected to strong criticisms in recent years.[72] If a bondholder decides to compel the trustee to take action or prefers to take action itself, it has to meet the conditions set out in the no-action clause. Each of them may present challenges in practice.

First, the request for action to the trustee has to be given by the bondholders holding no less than 20 per cent or 25 per cent[73] of the total outstanding bonds. In practice, it might be

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under an indenture while ignoring the indenture's restriction on its ability to sue": *Emmet v Catholic Health East* 37 Misc3d 854 (NY Sup Ct 2012) at 858.

71 It is possible to justify the court's decision on the substantial ground that breach of early redemption clause has not occurred. It is clear that, if Catholic Health were to be treated as the original issuer and being bound by the early redemption provision, its redemption of the remaining bond would not constitute any breach of the early redemption provision because any bonds bought back by Catholic Health would have already been cancelled. If Catholic Health were not to be treated as the issuer, then it should not be bound by the early redemption provision. The issue whether it breached the early redemption provision would not arise in the first place. It is not logical to treat Catholic Health as the issuer for the purposes of compliance with the early redemption provision, but not as the issuer in respect of the bonds it bought through the tender offer.

72 See for example Kahan, above n 19, at 1070–1077; Gadsden, above n 50, at 228; Rawlings, above n 29, at 23–24.

73 This percentage varies in practice.

difficult for a bondholder to meet this threshold requirement. The common practice in financial markets today is that the whole issue of the bonds is represented by a global security, which is held by or on behalf of an international or local clearing system. Each investor holds the bonds either directly in an account with such a clearing system (if it has an account) or through an accountholder. Due to the secrecy rules of the clearing systems, bondholders have no formal ways to find out the identities of other bondholders of the same bond issue.

Secondly, the waiting period presents another hurdle. Under the US no-action clause, after making a demand on the trustee, the bondholders have to wait 60 days before they can bring actions. This could prove to be too long in some cases. For example, in *Akanthos Capital Management v CompuCredit Holdings Corp*, the issuer announced its intention to pay a dividend (which the plaintiff intended to stop on the ground of fraudulent transfer) less than 60 days in advance. This did not give the plaintiff sufficient time to meet the 60-day requirement in the no-action clause.

In the eurobond context, the waiting period requirement is also troublesome. It provides that the bondholders may proceed only after the trustee fails to proceed "within a reasonable period". Given the inherent ambiguity of reasonableness, disputes are likely to arise. If the trustee has clearly indicated that it will not proceed, it may be safe to assume that the "reasonable period" should lapse immediately. However, if the trustee says that it is willing to take proceedings against the issuer, yet for some reason it has not done so, it would be difficult for the bondholders to determine whether a reasonable period has lapsed.

Thirdly, the bondholders are required to provide an indemnity to the trustee's satisfaction. While this requirement is reasonable, the trustee may be subject to counterclaims and other liabilities as a result of following the bondholders' request to take action. If the bondholders and the trustee cannot reach an agreement on an indemnity, the bondholders may ask the courts to intervene.[74] The problem is that, assuming the court agrees with the bondholders, it would mean that the trustee is bound to accept the indemnity given by the bondholders and follow their instruction. If the relevant instruction is a simple one, such as serving a notice of acceleration, then problems are less likely to arise. But if following the instruction requires substantial efforts and actions by the trustee (such as bringing proceedings), bondholders might be better off taking action themselves.[75]

As a final point, even assuming that bondholders are able to satisfy all the requirements in the no-action clause, they "may prefer to control the pursuit of the claim rather than having the claim brought by the trustee".[76] Due to the trustee's lack of incentives,[77] bondholders may justifiably suspect that the trustee may not pursue a remedy as vigorously as bondholders would do.[78]

6.5 Conclusion

The no-action clause is a crucial building block in the bond trust structure. In recent years, the no-action clause, and the bond trustee's role in general, have been subjected to an increasing level of scrutiny and challenge. This is due to the rising number of bond defaults, emergence

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74 In *Concord Trust v Law Debenture Trust* [2005] UKHL 27 at [34] Lord Scott observed: "It is, or should be, common ground that the Trustee cannot reasonably insist on an indemnity to cover [such] risk unless the risk is more than a merely fanciful one."

75 This is actually the approach recommended in the Revised Model Simplified Indenture. Under this approach, when the bondholders demand that the trustee take action, the trustee may ask for indemnity. If the parties cannot agree on the indemnity, the bondholders may then take action. See Revised Model Simplified Indenture, above n 18, at 1192.

76 Gadsden, above n 50, at 228.

77 Marcel Kahan and Edward Rock "Hedge Fund Activism in the Enforcement of Bondholder Rights" (2009) 103 NWULR 281 at 299.

78 The bondholder/trustee relationship presents a typical agency problem. This problem and its potential solutions will be discussed in a separate article.

of institutional activism[79] and, in the case of structured products, the increasing level of complexity in documentation.

In general, the courts have given broad interpretations to no-action clauses, holding that contractual claims as well as extra-contractual claims are prohibited by the clauses. This approach is justified on the basis that it is consistent with the function of the no-action clause, and it prevents "cause of action shopping". Nevertheless, in practice, the broad construction of no-action clauses constitutes a serious impediment to the pursuit by bondholders of their claims. Accordingly, checks and balances should be put in place to ensure that the interests of the bondholders are properly protected. For example, the trustee may be required to make certain information disclosure to the bondholders in respect of the enforcement actions it intends to take or is taking. Such information would enable the bondholders to determine whether the trustee's actions are in the interests of the bondholders, and communicate with the trustee should they have any concerns. In addition, bondholders should consider actively participating in the enforcement process through bondholder committees or other informal channels. The current mechanism under standard trust instruments for setting up a bondholder committee is cumbersome and not suitable for post-default situations.[80] Thus it would be desirable to have a separate (and simpler) set of procedural rules for the formation of a bondholder committee after a default has occurred.[81]

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79 Kahan and Rock, n 64, at 293; John J Chapman "Institutional Activism: Current Trends and Emerging Legal Issues" (2006) 44 CBLJ 327.

80 For example, under a typical eurobond trust deed, a committee can be set up under a bondholder resolution passed at a meeting. The meeting is convened by the issuer, either of its own volition or at the request by the bondholders holding no less than 10 per cent of the bonds. At least 21 days' notice shall be given to the bondholders.

81 See Esther Cavett "When the Music Starts Again: How Should Trustees Conduct Themselves in the New World?" (2010) 25 JIBFL 469 at 471.

CHAPTER 7 EXIT CONSENTS IN DEBT RESTRUCTURINGS

7.1 Introduction

In December 2015, after two Southern District Court of New York decisions and a suspicious attempt to retrospectively amend s 316(b) of the Trust Indenture Act of 1939 (US), the exit consent, a term otherwise only familiar to restructuring specialists, suddenly attracted an unusual amount of attention from capital markets practitioners, academics and even the mainstream public media.[1]

Exit consent is a technique mostly used in out-of-court distressed debt restructurings.[2] Typically, a bond issuer makes a conditional offer to bondholders to exchange their bonds for new bonds or other types of securities, or offer to buy the existing bonds back at a discounted price.[3] The conditions of the offer are usually: (a) the exchange offer is accepted by a majority of the bondholders; and (b) each tendering bondholder must give consent to a resolution which may release a group guarantee, strip off the protective covenants, or approve the issuer to

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1 See for example Max Frumes, Angelo Thalassinos and Sarah Gefter "The Mysterious Shelved Amendment To The Transportation Bill That Would Divide Billionaires" (4 December 2015) Forbes <www.forbes.com>; Matt Jarzemsky "Caesars Takes Aim at Law Aiding Creditors" (6 December 2015) The Wall Street Journal <www.wsj.com>; Adam J Levitin and others "Comment Letter of 18 Law Professors on the Trust Indenture Act" (11 December 2015) Harvard Law School Forum on Corporate Governance and Financial Regulation <www.harvard.edu>; Marian Baldwin Fuerst, Christy L Rivera and Douglas E Deutsch "The Trust Indenture Act: What is All the Fuss About?" (25 February 2016) Law360 <www.law360.com>.

2 For an empirical study of out-of-court restructurings versus Chapter 11 bankruptcy, see Stuart C Gilson, Kose John and Larry HP Lang "Troubled Debt Restructurings: An Empirical Study of Private Reorganization of Firms in Default" (1990) 27 Journal of Financial Economics 315.

3 In this chapter, the term 'bond' is used in a generic sense and includes debentures, bonds or notes, whether secured or unsecured. For a general discussion of the terminology, see Geoffrey Fuller *Corporate Borrowing: Law and Practice* (4th ed, Jordans, London, 2009) at 35 and 317–320.

transfer its substantial assets to another entity, thereby reducing or even destroying the value of the existing bonds.[4]

From a bond issuer's perspective, there are three reasons why it is necessary or preferable to adopt the exit consent technique in a restructuring. First, if the applicable law or the relevant bond terms require a unanimous consent in respect of amending certain payment terms, a single bondholder will have the capability to frustrate the restructuring process by refusing to give consent, hoping to extract additional value from the issuer at the expense of other bondholders (the holdout problem).[5] The exit consent provides a solution to the holdout problem. Under an exit consent arrangement, holdout bondholders will be left with worthless bonds, although their formal right to receive payment of the principal and interest remains intact on paper.

Secondly, adopting the exit consent technique may increase the chances of the exchange offer being accepted by a majority of bondholders due to a psychological phenomenon called the Prisoner's Dilemma. In essence, assuming that each bondholder has no information as to whether other bondholders will accept or reject the exchange offer, a rational bondholder will always choose to accept the exchange offer, irrespective of whether or not the exchange offer

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4 For an economic analysis of the exit consent, see Royce de R Barondes "An Economic Analysis of the Potential for Coercion in Consent Solicitations for Bonds" (1994) 63 Fordham L Rev 749. For a discussion of the 'reverse exit consent' technique, see Mitu Gulati and Jeromin Zettelmeyer "Making a Voluntary Greek Debt Exchange Work' (2012) 7 CMLJ 169.

5 See Lewis S Peterson "Who's Being Greedy? A Theoretical and Empirical Examination of Holdouts and Coercion in Debt Tender and Exchange Offers" (1993) 103 Yale LJ 505. A well-featured example of the holdout problem is the Argentinian sovereign debt restructuring. After Argentina defaulted on its foreign debts in 2001, a total of 93% of the bondholders participated in two rounds of restructuring in 2005 and 2010 respectively, receiving around 35% of face value. However, a group of hedge fund bondholders refused to participate and brought successful litigations against Argentina. In February 2016, a settlement of US$9.3 billion was reached between the Argentina government and the group of holdout investors, representing several times worth of the initial price paid by those investors. See Alexandra Stevenson "How Argentina Settled a Billion-Dollar Dispute With Hedge Funds" (25 April 2016) The New York Times <www.nytimes.com>.

will be accepted by a majority in the end.[6] To a certain degree, it can be said that each bondholder is coerced into accepting the exchange offer because that is what a rational bondholder should do. Obviously, this coercive effect can raise questions of fairness and potentially make it the subject of litigation. One caveat should be noted here. The Prisoner's Dilemma is premised on a lack of coordination among bondholders. However, empirical evidence shows that, in cases where the bondholders are institutional investors, they can and do coordinate their actions in response to an exchange offer.[7]

The third reason for a bond issuer to use the exit consent technique is more benign than the second one, although it also relies on the coercive effect of the exit consent. Under standard bond terms, resolutions may be passed at a bondholders' meeting only if a quorum requirement is met. Therefore, it is possible that in some cases the exchange offer fails not because the offer is rejected by the majority of the bondholders present at the bondholders' meeting, but because the number of bondholders attending the meeting does not meet the quorum requirement.[8] The exit consent technique may increase the chances of the quorum requirement being met, because it incentivises otherwise passive bondholders into voting – in the event that the restructuring

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6 For a full explanation of the Prisoner's Dilemma in the context of exit consent, see John C Coffee Jr and William A Klein "Bondholder Coercion: The Problem of Constrained Choice in Debt Tender Offers and Recapitalizations" (1991) 58 UCLR 1207 at 1224–1233.

7 Marcel Kahan and Bruce Tuckman "Do Bondholders Lose from Junk Bond Covenant Changes?" (1993) 66 Journal of Business 499; Ran Bi, Marcos Chamon and Jeromin Zettelmeyer "The Problem that Wasn't: Coordination Failures in Sovereign Debt Restructurings" (IMF Working Paper, WP/11/265, November 2011).

8 The failure of bondholders to participate in the voting process may be due to various reasons, such as negligence or lack of interest. In recent years, it is possible that the problem of lack of participation may have been aggravated by the 'empty creditor' problem caused by the rapid expansion of credit derivatives markets. In essence, a bondholder which has hedged its credit exposure will be indifferent to the bond issuer's survival. See Henry TC Hu and Bernard Black "Equity and Debt Decoupling and Empty Voting II: Importance and Extensions" (2008) 156 U Pa L Rev 626; Daniel Hemel "Empty Creditors and Debt Exchanges" (2010) 27 Yale J Reg 159. Compare David Mengle "The Empty Creditor Hypothesis" (17 December 2009) Social Science Research Network <www.ssrn.com>.

resolution is passed, the bondholders who fail to vote will be stuck with the original bonds but with less favourable terms. This is in contrast to the normal restructuring where all bondholders, including the non-participating bondholders, will be treated in the same way if the amendment resolution is passed.

The use of exit consent in debt restructurings originated in the United States in the 1980s, and spread to the London market in the early 2000s.[9] An exit consent provides a relatively quick and inexpensive way of structuring the debt of a distressed company, thus avoiding the high costs and delay of bankruptcy.[10] Until 2015, relying on a limited amount of US case law, the common view shared by market participants was that an exit consent was legally valid. However, this view was thrown into serious doubts after the 2015 rulings of the United States District Court for the Southern District of New York in *Marblegate Asset Management v Education Management Corp* (*Marblegate*)[11] and the Caesars litigation (*Caesars*).[12] In each case, the district court held that arrangements of an exit consent which stripped off restrictive covenants violated s 316(b) of the TIA on the ground that such arrangements impaired the bondholders' 'practical right' to receive payment, even though the bondholders' legal rights were left formally intact. In the London market, exit consents did not fare well either – in *Assenagon Asset Management SA v Irish Bank Resolution Corp Ltd (formerly Anglo Irish Bank*

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9 Mark J Roe "The Voting Prohibition in Bond Workouts" (1987) 97 Yale LJ 232; James Cole "How to Apply US-style Exchange Offers in Europe' (2002) 21 IFLR 52.

10 The exit consent technique has also been used in sovereign debt restructurings, such as the 2000 Ecuador restructuring, the 2003 Uruguay restructuring and the restructuring of Belize's sovereign debt in 2007. For a discussion of exit consents in the context of sovereign bond restructurings, see Lee C Buchheit and G Mitu Gulati "Exit Consents in Sovereign Bond Exchanges" (2000) 48 UCLA L Rev 59.

11 75 F Supp 3d 592 (SD NY 2014) (decision on application for a preliminary injunction) (*Marblegate I*); 111 F Supp 3d 542 (SD NY 2015) (judgment on the merits) (*Marblegate II*).

12 *MeehanCombs Global Credit Opportunities Fund, LP v Caesars Entm't Corp* 80 F Supp3d 507 (SD NY 2015) (Caesars I); *BOKF, NA v Caesars Entertainment Corp* 144 F Supp3d 459 (SD NY 2015).

Corp Ltd),[13] the UK High Court held the exit consent arrangement in that case was invalid because the consenting bondholders abused their power to vote.

This chapter offers a comparative study of the validity of exit consent under the US law and English law. Part 7.2 focuses on *Marblegate* and *Caesars*, and argues that the expansive interpretation given by the US District Court in New York is inconsistent with the legislative history of s 316(b) and the usage of the term 'impairment of a right' in other contexts. It also discusses whether a removal of guarantee, in and of itself, violates s 316(b). Part 7.3 argues that the UK High Court reached the wrong decision in *Assenagon* by holding that the consenting bondholders abused their power. Part 7.4 looks at a third possible legal theory by which a disgruntled bondholder may challenge an exit consent: by making an exchange offer coupled with an exit consent, the bond issuer has breached English company law. It is submitted that, given the similarities between consent payments and exit consents, and consent payments having been held to be lawful by the UK Court of Appeal in *Azevedo v IMCOPA - Importacao, Exportaacao e Industria de Oleos Ltda* ("*Azevedo*"),[14] it is likely that exit consents are also lawful as a matter of company law, so long as the issuer acts in a clear and transparent manner. Part 7.5 concludes.

7.2. Section 316(b)

The TIA applies to publicly issued bonds governed by US law. Section 316(b) of the TIA provides that "[n]otwithstanding any other provision of the indenture to be qualified, the right of any holder of any indenture security to receive payment of the principal of and interest on such indenture security, on or after the respective due dates expressed in such indenture security, or to institute suit for the enforcement of any such payment on or after such respective

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[13] [2012] EWHC 2090 (Ch).

[14] [2013] EWCA Civ 364.

dates, shall not be impaired or affected without the consent of such holder".[15] The purpose of this provision is to prohibit issuers of public bonds including in indentures collective action clauses under which the payment rights of the minority bondholders may be jeopardised by the majority.

To a distressed issuer, s 316(b) presents a major hurdle to its debt restructuring efforts because the issuer has to obtain the unanimous consent of the bondholders if the issuer wants to reduce the principal amount or the interest rate or to postpone a payment date. This requirement gives a unique power to each individual bondholder to hold the whole group to hostage. In practice, the exit consent technique can be used to address the holdout problem. However, exit consents could be attacked as a breach of s 316(b) in two alternative routes: practical impairment and impairment of the right to receive payment from the guarantor.

7.2.1 Practical impairment

Prior to the *Marblegate* and *Caesars* decisions of the US District Court in New York, the general view of the market, relying on other case law, was that a majority bondholders' resolution to remove protective covenants or approve of an asset sale was not prohibited under s 316(b). This view was based on a handful of cases on s 316(b). The first such case was *Schallitz v Starrett*.[16] In this case, after the holders of 71% of the outstanding bonds consented, the indenture trustee executed with the issuer a supplemental indenture which removed certain covenants which required the issuer's subsidiaries to hand over their net profits to the issuer. Adopting a restrictive approach of interpretation, the Court held that the amendment did not

15 While the TIA applies only to public bonds, many non-TIA qualified indentures contain a provision that tracks Section 316(b).

16 82 NYS 2d 89 (NY Sup Ct 1948).

violate s 316(b), because the statute "does not prohibit the incidental effect upon income interest caused by diminution in dividends from other sources."[17]

In *Federated Strategic Income Fund v Mechala Grp Jamaica Ltd* (*Mechala*),[18] s 316(b) was considered in the context of an exit consent for the first time. The issuer offered bondholders a cash price of 45 cents on the dollar, provided that the tendering bondholders consent to a resolution which would remove the guarantees given by the issuer's subsidiaries. In addition, the resolution would also delete certain restrictive covenants from the indenture, such as consenting to jurisdiction in New York, maintaining an agent in New York, a waiver of immunities, and events of default. A bondholder brought an action to seek a preliminary injunction from the United States District Court for Southern District of New York. The court granted the injunction, holding that the proposed amendments, taken together, "could materially impair or affect a holder's right to sue."[19] "It is beyond peradventure that when a company takes steps to preclude any recovery by noteholders for payment of principal coupled with the elimination of the guarantors for its debt, that such action does not constitute an "impairment" or "affect" the right to sue for payment."[20]

While the *Mechala* decision was a departure from the then general understanding of the market, its impact seemed to be limited.[21] The market continued to operate on the assumption that an exit consent was lawful, relying on cases such as *Magten v Northwestern Corp*

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17 At 91.

18 WL 993648 (SD NY 1999).

19 At 7.

20 At 7.

21 For a discussion of the possible reasons, see Ben H Logan "The Trust Indenture Act, Debt Restructuring and Reorganization Tourism (Part I)" (2016) 36(3) Bankruptcy Law Letter.

(*Magten*)[22] and *Brady v UBS Fin Servs Inc* (*Brady*).[23] In *Magten*, a bondholder sought to challenge the legality of an asset transfer between a parent company and its subsidiary on the basis that the transaction impaired its rights under the indenture to receive payment of principal and interest and therefore the transaction had to be approved by all the holders. The court rejected this argument, holding that s 316(b) "applies to the holder's legal rights and not the holder's practical rights to the principal and interest."[24]

The common view that exit consent was not prohibited by s 316(b) was reinforced by the decision of the US District Court for the District of Kansas in *YRC Worldwide, Inc v Deutsche Bank Trust Company America*.[25] In this case, as part of a restructuring effort, the issuer sought to convert its bonds into equity. Obviously this required a unanimous consent of the bondholders, as conversion into equity would constitute a direct impairment of the holders' right to receive principal and interest. The issuer adopted the exit consent technique by making an exchange offer to the holders of these notes. Under the terms of the offer, the holders could exchange their bonds for equity in the issuer provided that they consented to amend the indenture by deleting s 3.08, s 5.01 and other provisions of the trust indenture. Under s 3.08, holders were entitled to require the issuer to buy back bonds on certain dates (the put rights).[26] Under s 5.01, the issuer was prohibited from transferring all of its assets to another entity unless another entity assumed its debts. Over 90% bondholders agreed. However, the trustee refused

22 313 BR 595 (Bankr D Del 2004).

23 538 F3d 1319 (10th Cir 2008).

24 *Magten*, above n 22, at 600.

25 WL 2680336 (D Ct Kan 2010).

26 It is easy to see why the issuer would want to delete s 3.08. Under this section, the earliest date on which a bondholder was entitled to demand early redemption was in August 2010, less than one year from the date of the exchange offer.

to sign the supplemental indenture because it believed that this deletion required a unanimous consent from the holders. As a result, the issuer brought a declaration judgment action.

The court held that the deletion of s 3.08 did require a unanimous consent, as the right to demand early redemption was a payment right protected by s 316(b).[27] This conclusion seems uncontroversial – after all, the put rights are a type of legal rights to receive payments.[28]

As to the deletion of s 5.01, the court reached a different conclusion. Following *Magten* and *Brady*, the Court held that s 316(b) "does not provide a guarantee against the issuing company's default or *its ability to meet its obligations*" (emphasis added).[29] Accordingly, deletion of s 5.01 without a unanimous consent did not violate s 316(b). The court distinguished *Mechala* on a factual ground: in *Mechala*, the issuer was divesting its assets, whereas in the present case, there was no basis to conclude that the amendments would necessarily impair the bondholders' practical rights to receive payments under the bonds.[30]

The US District Court decision in *Marblegate*

Education Management LLC (EDM) is one of the largest education providers in the United States. In 2014, it found itself in deep financial trouble. At that time, it had about US$1.3 billion secured debt and US$217 million unsecured bonds, against total assets of US$1.05 billion. The secured debt and the unsecured bonds were guaranteed by EDM's parent company, Education Management Corporation (EMC). The indenture of the bonds provided that the

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27 WL 2680336 (D Ct Kan. 2010) at 4.

28 In the end, most of the holdout bondholders exercised their put rights in August 2010 and received full payment. See YRC Worldwide Inc. Form SC TO–I/A (Amended tender offer statement by Issuer) <http://files.shareholder.com/downloads/YRCW/0x0xS1193125-10-183193/716006/filing.pdf>.

29 WL 2680336 (D Ct Kan 2010) at 7.

30 At 7.

guarantee of the bonds would be automatically released if secured lenders released the guarantee of the secured debt.

EDM and a committee set up by the creditors designed a restructuring plan containing two parts: Plan A and Plan B. Under Plan A, assuming 100% participation, the unsecured bonds would be exchanged for common stock of EMC, representing a recovery of roughly 33%. However, if participation in the exchange offer was less than 100%, the secured lenders would conduct a foreclosure sale of EDM's assets to its sister company (New EDM) also held by EMC (Plan B). Each of the participating bondholders would receive from the New EDM the same consideration that they would have received under Plan A. In addition, the secured lenders would release the guarantee of the secured debt, resulting in the guarantee of the unsecured bonds being automatically released. In the end, the bondholders who rejected the exchange offer would be left with claims against an empty shell and no guarantee claim against EMC.

Over 90% of the bondholders accepted the exchange offer. As a result, Plan B was implemented. A foreclosure sale took place, and the parent guarantee was released in due course. Two bondholders, holding around 6.5% of the unsecured bonds in total, took objection and brought proceedings in court. One interesting aspect of the dynamics in this case is that, being a for-profit education provider, Chapter 11 bankruptcy was not a realistic option to EDM because a bankruptcy filing would automatically terminate its eligibility for federal funding which is nearly 80% of its revenue. This placed the holdout bondholders in a more advantageous position compared to other normal corporate restructurings.

In the decision on an application for a preliminary decision, Failla J rejected the argument that s 316(b) protected legal rights only. However, Failla J also recognised that a general practical impairment interpretation would mean that anything done by the issuer, such as bad business decisions which, in hindsight, might have negatively affected the bondholders' ability to receive payment could potentially constitute a breach of s 316(b).[31] Relying on the legislative history, Failla J was able to strike a middle ground, holding that s 316(b) precluded "a debt reorganization that seeks to involuntarily disinherit the dissenting minority".[32] In the follow-up decision on the merits, Failla J found that the relevant restructuring plan did contravene s 316(b), and ordered that EMC shall continue to guarantee the payments under the bonds owned by the plaintiffs.[33]

Leaving aside the merits of the reasoning of Failla J for the moment, the practical effect of the decision is that the two plaintiffs would, ironically, receive a full recovery of the bonds, a result even better than the secured lenders. Fortunately, as will be seen below, the US Court of Appeals overturned Failla J's decision, preventing the plaintiffs from getting a windfall at the expense of other creditors.

The US District Court Decision in *Caesars*

The bond issuer in this case, Caesars Entertainment Operating Company, Inc (CEOC), owns and operates casinos and hotels throughout the United States. The bonds were guaranteed by its parent, Caesars Entertainment Corporation (CEC). The bond terms provided that the guarantee could be released by way of a majority resolution of the bondholders. As a result of a deep recession and fierce competition, CEOC's profits plummeted. In 2014, it bought back bonds from a majority of bondholders at par, on the condition that those bondholders would give an exit consent to the removal of the CEC guarantee, and modify the indenture provisions regarding the sale of CEOC's assets. A supplemental indenture was executed in due course, effecting the amendments consented to by the bondholders. Two bondholders, who were not given the opportunity to sell their bonds to CEOC, brought proceedings against both CEOC and

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31 *Marblegate I*, above n 11, at 613.

32 *Marblegate I*, above n 11, at 615.

33 *Marblegate II*, above n 11, at 556–557.

CEC. CEC filed a motion to deny the action. At the time of hearing, the action against CEOC was stayed due to an involuntary chapter 11 petition against it in Delaware.

The key argument of the plaintiffs was that the release of the guarantee affected their practical ability to recover payment in violation of s 316(b). Adopting an approach similar to *Marblegate*, Scheindlin J held that removal of the guarantee was an impermissible out-of-court debt restructuring which s 316(b) was designed to prevent.[34] CEC's motion to dismiss the action was denied.[35]

Practical impairment of a right

It would not be an overstatement to say that the rulings of the US District Court in New York in *Marblegate* and *Caesars* were a radical department from the general view of the market. The Loan Syndication & Trading Association and the Chamber of Commerce stated the *Marblegate* ruling was "revolutionary" and could even affect the entire $8 trillion loan market.[36] Many commentators, including practitioners and academics, have aired strong criticism on the reasoning of the district court in these two cases.[37] Indeed, there are a number of problems with these two decisions. Two are discussed below.

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34 *Caesars I*, above n 12, at 516.

35 Since then, the bondholders, CEC and its private equity backers have battled it out in the bankruptcy court, and reached a settlement representing a 66-cent on the dollar recovery.

36 Steven Church and Tiffany Kary "'Revolutionary' Distressed-Debt Case Argued in NYC Appeals Court" (12 May 2016) Bloomberg <www.bloomberg.com>.

37 See for example Jack Butler "The Examiners: It's Bad Public Policy to Empower Holdout Bondholders" *The Wall Street Journal* (1 October 2015) The Wall Street Journal <www.wsj.com>; Kenneth N Klee "How Judges Are Skewing Bond Law" (8 November 2015) The Wall Street Journal www.wsj.com; Logan, n 21; Harald Halbhuber "Debt Restructuring and the Trust Indenture Act" (2017) 25 Am Bankr Inst L Rev (forthcoming); Richard L Epling and Dina E Yavich "When Can a Bondholder Insist on Prompt Payment of Principal or Interest: Recent Developments under the Trust Indenture Act" (2016) Norton Annual Survey of Bankruptcy Law 7. Compare Mark J Roe "The Trust Indenture Act of 1939 in Congress and the Courts in 2016: Bringing the SEC to the Table" (2016) 129 Harvard Law Review Forum 360.

First, in reaching the conclusion that s 316(b) precluded a practical impairment in an out-of-court reorganisation, *Marblegate* relied heavily on the legislative history of the TIA.[38] Indeed, the reports of the House and Senate subcommittees responsible for drafting the TIA did state that "[evasion] of judicial scrutiny of the fairness of debt-readjustment plans is prevented by [s 316(b)]".[39] However, as convincingly pointed out by one commentator, the foreclosure-based restructurings as adopted in *Marblegate* already existed prior to the enactment of the TIA and was generally accepted in the then market.[40] In addition, at the time that the TIA was enacted, some bond indentures already contained the non-impairment provision in a wording similar to s 316(b). Yet, it did not occur to anyone that the provision would have prohibited foreclosure-based restructurings. Therefore, it is unlikely that Congress' intention behind s 316(b) was to outlaw such transactions. Instead, its purpose was to combat a new trend of indenture drafting – a collective action clause which allowed the majority to amend payment terms. If a dissenting holder wanted to challenge this on the ground of fraud or bad faith, it must have a creditor status. Section 316(b) was meant to preserve the bondholder's creditor status.[41]

The second problem is a more general one. Both Failla J and Scheindlin J took the view that the concept of an "impairment of a right" could be interpreted as including not just an impairment of the bondholder's formal legal right, but also an impairment of the bondholder's practical ability to receive payments due under the bonds. This interpretation does not seem to be consistent with the plain language of s 316(b). The word "right" in s 316(b) certainly means "legal right". Therefore, "impairment of a right" should be taken to mean a loss of, a change of nature of, or an imposition of condition on the existing legal right. In fact, this is how this term

38 *Marblegate I*, above n 11, at 613; *Marblegate II*, n 11, at 547–553.

39 HR Rep 76–1016, 56 (1939); S Rep No 76–248, 26–27 (1939).

40 *Halbhuber*, above n 37, at 7–8.

41 *Halbhuber*, above n 37, at 37. See also Logan, above n 21, at 17–18.

is used in other contexts, such as impairment of a person's property right or contractual right by the government through legislation;[42] impairment of non-governmental organisations' right to take action in a court of law;[43] or the impairment of a farmer's right to sell potatoes into Western Australia because of the proximity of their operations to the land to which the defendant had supplied infected seed.[44]

In this context, it is important to distinguish two related, but distinct, concepts. A legal right to payment is enforceable in its own right: if the legal right is lost due to the action or omission of the obligor or a third party, the owner of the right will have a claim against that person. In contrast, the "practical ability" to recover payment under a legal right reflects the value of the legal right. The value of a legal right to payment may decrease due to a variety of reasons, such as the obligor becoming less creditworthy. As long as the formal legal right remains intact, the fact that the value of that legal right is diminished or lost due to the action or omission of the obligor or a third party does not, by itself, give rise to a claim against the obligor or the third party. Such a claim, if it does exist, has to be based on a separate cause of action under common law or in equity.

The Second Circuit decision in *Marblegate*

In January 2017, the Second Circuit Court of Appeal issued the much-anticipated ruling in the *Marblegate* appeal.[45] By 2:1, the court overturned Failla J's decision. Lohier J delivered

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42 See for example J Murray Ferron "The Constitutional Impairment of the Rights of Secured Creditors in Canada and the United States" (1986) 60 CBR (NS) 146.

43 C–115/09 *Bund fur Umwelt und Naturschutz Deutschland, Landesverband Nordrhein-Westfalen eV v Bezirksregierung Arnsberg* (ECJ, 12 May 2011).

44 *Perre v Apand Pty Ltd* [1999] HCA 36.

45 *Marblegate Asset Management v Education Management Finance Corp* Nos 15–2124, 15–2141, 2017 US App LEXIS 782, *1 (2nd Cir 2017).

the majority opinion. After stating that the text of s 316(b) was ambiguous,[46] Lohier J reviewed the legislative history behind s 316(b), and concluded that s 316(b) only prohibited non-consensual amendments to an indenture's core payment terms.[47] The judge also noted that such interpretation should not leave dissenting bondholders at the mercy of bondholder majorities. Instead, they are entitled to pursue available State and federal law remedies, relying on the creditor status preserved under s 316(b) under the narrow interpretation adopted by the court.[48]

The Court of Appeal decision should be welcomed, as it provides the much-needed certainty and relief to the debt restructuring market. However, this decision may not be the final word on the practical impairment argument. Given the amount of money at stake, the dissenting bondholders may further appeal to the US Supreme Court.

7.2.2 Impairment of the right to receive payment from the guarantor

In each of *Marblegate* and *Caesars*, the guarantee of the bonds was removed as part of the restructuring, albeit in different ways. In *Marblegate*, the guarantee was removed in accordance with the terms of the indenture, as the indenture provided that, upon the release of EMC' guarantee of the secured debt, the guarantee of the unsecured bonds would be automatically released. In *Caesars*, the guarantee was released under the exit consent given by the majority bondholders. The claims of the bondholders in these two cases were that the removal of the guarantee, together with other transactions contemplated in the relevant restructuring, violated s 316(b) because such removal constituted a practical impairment of the bondholders' right to receive payment from the bond issuer.

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46 At 13–16.

47 At 33.

48 At 40.

A separate issue is whether a removal of guarantee, in and of itself, violates s 316(b) on the basis that it impairs the bondholder's right to receive payment from *the guarantor*. It is reasonably clear that, where a guarantee is released in accordance with the terms of the indenture (as in *Marblegate*), s 316(b) is not breached. In fact, in some cases, the terms of bonds provide that the payment rights of the bondholders may be reduced or lost upon the occurrence of certain events. It would be absurd to suggest that such bond terms violate s 316(b).

However, where a guarantee is removed under a resolution of the majority bondholders passed under the exit consent, a dissenting bondholder may claim that its right to receive payment from the guarantor is impaired. It has been argued that, based on a plain language reading of the TIA, s 316(b) does cover guarantors.[49] Specifically, under the TIA, the definition of "indenture security" includes guarantees,[50] and the definition of "obligor" includes guarantors.[51]

The commercial rationale supporting the view that s 316(b) covers guarantee is that, from a bondholder's perspective, a right to receive payment from the guarantor is as important as the right to receive payment from the bond issuer.[52] On the other hand, however, if s 316(b) does prohibit a removal of guarantee, it would seriously affect a normal business merger and

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49 See for example Adam J Levitin "The Trust Indenture Act Rider is Not a "Clarifying Amendment"' (10 December 2015) Credit Slips <www.creditslips.org>; James H Millar "*Marblegate v EDMC*: What Does the Second Circuit's Opinion Say (and Not Say) about Releasing a Guarantee?" (1 February 2017) Drinker Biddle <www.drinkerbiddle>.

50 Under s 303(11) of the TIA, 'indenture security' means any security issued or issuable under the indenture to be qualified. The term 'security' is not defined in the TIA. However, s 303 provides that "any term defined in s 2 of the Securities Act of 1933, and not otherwise defined in this section, shall have the meaning assigned to such term in such section 2." Section 2(a)(i) of the Securities Act of 1933 defines "security" to mean "any note, … bond, debenture, … guarantee of … any of the foregoing".

51 Section 303(12) of the TIA.

52 Levitin, above n 49.

acquisition, because a bond issuer would effectively be prohibited from selling the business owned by the guarantor.[53]

It is also questionable whether this interpretation is consistent with the legislative intent behind s 316(b). As discussed above, s 316(b) is not meant to protect the value of a bondholder's right, but to preserve the bondholder's creditor status.[54] As long as the bondholder has a creditor status, it will then able to sue under fraudulent transfer or other equitable principles if its practical ability to receive payment has been impaired. On this basis, it is difficult to see why the bondholder' right against a guarantor needs to be entrenched in the same way as its right against the bond issuer.

Given all the uncertainties and controversies surrounding s 316(b), it is worthwhile to consider whether s 316(b) should be abolished.[55] In fact, the bond market today is drastically different from the market seventy years ago when the TIA was enacted. The market is heavily dominated by institutional investors. Rather than offering protections to mum and dad investors, s 316(b) is now more often used by sophisticated institutional investors to extract extra value from the issuer at the expense of other bondholders. The original justification for s 316(b) no longer holds.

In the light of the recent US Court of Appeals decision in *Marblegate*, there is probably less urgency to abolish s 316(b). However, s 316(b) may still present a legal risk in cases where the guarantee of the bonds needs to be removed. Issuers who want to have a greater flexibility

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53 Logan, above n 21, at 15.

54 See the text to n 41.

55 See Carlos Berdejó "Revisiting the Voting Prohibition in Bond Workouts" (2015) 89 Tul L Rev 541; Ben H Logan "The Trust Indenture Act, Debt Restructuring and Reorganization Tourism (Part II)" (2016) 36(4) Bankruptcy Law Letter.

to restructure their bonds may need to choose not to qualify under the TIA and have more robust collective action clauses in trust indentures.[56]

7.3 Bondholders' duties

The second way for a dissenting bondholder to attack exit consents is to allege a breach of a collateral obligation by the consenting bondholders. Specifically, the dissenting bondholder claims that the amendment of the bond terms is invalid because the consenting bondholders abused their power by acting not in the best interests of all the bondholders as a whole, or acting oppressively or unfairly (the abuse principle).[57]

In the late 19th century, the abuse principle was applied in bondholder cases both in England and the United States.[58] Since then, there has been a dearth of the US cases which directly discussed the abuse principle, probably due to the fact that bondholders' payment rights are protected under s 316(b).[59] In England, dissenting bondholders continued to rely on the abuse principle to challenge the validity of the resolutions in courts.[60] However, it was not until

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56 In cases where opting out of the TIA is not practical, the issuer can seek exemptions from the Securities and Exchange Commission which has broad exemptions authority. See Roe, above n 37, at 16–18.

57 While the abuse principle is embedded in the case law in the UK, it has been codified in some jurisdictions (for example Singapore). Accordingly, dissenting bondholders alleging oppression may invoke statutory provisions. See for example Jerry Koh and Evangeline Oh "Re-Examining Bondholders' Rights in Exchange Offers" (2015) 16 Bus L Int'l 119 at 132–133.

58 See for example *Mercantile Investment and General Trust Company v International Company of Mexico* (1893) 1 Ch 484; *Follit v Eddystone Granite Quarries* [1892] 3 Ch 75; *Hackettstown Nat Bank v D G Yuengling Brewing Co* 74 F 110 (2nd Cir 1896) (*Hackettstown*).

59 Lee C Buchheit and G Mitu Gulati "Exit Consents in Sovereign Bond Exchanges" (2000) 48 UCLA L Rev 59 at 76.

60 See for example *Goodfellow v Nelson Line (Liverpool), Ltd* [1912] 2 Ch 324*; In re New York Taxicab Co* [1913] 1 Ch 1; *British America Nickel Corp Ltd v MJ O'Brien Ltd* [1927] AC 369. The abuse principle permeates many areas of English company law. See eg *In re NFU Development Trust Ltd* [1972] 1 WLR 1548; *Ebrahimi v Westbourne Galleries Ltd* [1973] AC 360; *O'Neill v Phillips* [1999] UKHL 24; 1 WLR 1092.

Assenagon that the English court, for the first time, applied the abuse principle in the context of an exit consent.

7.3.1 *Assenagon*

The case occurred against the backdrop of the 2008 Global Financial Crisis. Anglo Irish, a bank in Ireland, was in deep financial distress and was nationalised by the Irish government in 2009. As part of the restructuring, Anglo Irish launched an exchange offer to its bondholders under which the bondholders could exchange their current bonds for new bonds in an exchange ratio of 5:1, provided that they would vote in favour of a resolution which would allow Anglo Irish to redeem the existing bonds at an astonishing amount of €0.01 per €1,000 notes. The resolution was passed at the bondholders meeting with more than 90% supporting.[61]

One bondholder, Assenagon Asset Management SA, did not participate in the exchange. As a result, they received €170 for their bonds with a face value of €17 million. It sought a declaration in the English High Court that the resolution was invalid. One of the grounds relied upon by the claimant was that passing the resolution constituted an abuse of the majority's voting powers.[62]

The bond issuer argued that the majority did not abuse their voting powers because, while the resolution in itself did not bring any conceivable benefit to the bondholders, its effect had to be viewed together with the exchange offer which was beneficial to the bondholders. Briggs J rejected this argument, holding that it was not lawful for the majority to "lend its aid to the coercion of a minority by voting for a resolution which expropriates the minority's rights under

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61 This is understandable, in the light of the dire situation of Anglo Irish and the Irish government's threat that, should the proposal fail, it would pass laws to reduce the entitlements of the bondholders.

62 The other two grounds are that (a) the majority had no power to pass the resolution pursuant to the terms of the bond trust deed; and (b) at the time of the bondholders meeting, the bonds were held to the benefit of the issuer and so they had to be disregarded for voting purposes.

their bonds for a nominal consideration".[63] "The exit consent is, quite simply, a coercive threat which the issuer invited the majority to levy against the minority… This form of coercion is in my judgment entirely at variance with the purposes for which majorities in a class are given power to bind minorities."[64]

7.3.2 Analysis

The outcome of *Assenagon* came as a surprise to the market and has drawn some criticism.[65] There are a number of objections. Three are covered here.

Firstly, it is questionable whether the abuse principle is applicable to exit consent cases like *Assenagon*. There is a crucial difference between *Assenagon* and other traditional cases in which the abuse principle has been applied. In those cases, there is a definitive holder or a group of holders who constitute the majority before any challenged resolution is approved. When the majority votes in favour of a resolution which is later challenged by the minority, each member voting in favour is aware that it is a member of the majority, and it is exercising its power for its own interest at the expense of the minority. As such, the court is able to say that, at the time of voting, the conscience of that particular person is tainted, and such exercise of power is an abuse. *In re Holders Investment Trust Ltd* provides a good illustration.[66] In this case, a proposal

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63 *Assenagon*, above n 13, at [84].

64 *Assenagon*, above n 13, at [85].

65 See for example Michael Doran and Sylvana Lee "Bond Exit Consents: No Way Out?" (30 August 2012) White & Case <www.whitecase.com>; Stephen Moverley Smith and Harry Sharpe "An Offer You Can't Refuse: When Does Coercion of a Group to Accept a Proposal Constitute Oppression of the Minority?" (2014) 29 JIBFL 288; Davis Polk "Exit Consents Unlawful under English Law" (30 July 2012) <www.davispolk.com>. Compare Clifford Chance "Liability Management: Exit Consents and Oppression of the Minority" (31 July 2012) <www.cliffordchance.com>. For the reactions of market participants in general, see Mary Watkins and Jane Croft "Court Ruling Poses Questions for Bondholders" (3 August 2012) Financial Times <www.ft.com>.

66 [1971] 1 WLR 583.

was put to holders of redeemable preference shares. Under the proposal, all preference shares would be cancelled and replaced with loan stock. The proposal was approved by a majority of the preference shareholders. The majority were also holders of 52 per cent of the company's ordinary shares. The court held that the resolution was invalid because the majority preference shareholders had considered what was best in their own interest based on their equity shareholding, rather than what was best for preference shareholders as a whole.[67]

In contrast, there was not a pre-existing majority in *Assenagon*.[68] Every bondholder was in the same position before the proposal. Each consenting bondholder became a member of the majority group only after making a rational choice to accept the offer. It is difficult to see how the bondholder is acting unfairly, or abusing its power, when the bondholder is behaving rationally, with the knowledge that, as long as other holders also make a rational choice, they would receive the same return. In other words, simply by being part of those who voted for the resolution cannot constitute fraud on the minority.

Secondly, it can be argued that the abuse principle is contracted out in an exit consent situation. There is a school of thought that equitable rules and principles, such as fraud on the power and fiduciary obligations, are only a gap-filing device. They are no more or less than

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67 Other examples include *Hackettstown*, above n 58, where a bondholder who held over 50% of the outstanding bonds and having been given a personal guarantee by the principal shareholder of the issuer voted in favour of a resolution which postponed the interest payments on the bonds; *British America Nickel*, n 60, where a bondholder, who had been promised to give him \$2 million of the ordinary stock of the issuer, voted in favour of a resolution which compelled the bondholders to exchange their bonds for new bonds. Without his vote, the resolution would not have passed.

68 In terms of bonds governed by English law, the law does not impose any unanimous consent requirement, nor is such a requirement contained in standard bond terms. Accordingly, if a bond issuer chooses to use the exit consent technique, its purpose is not to circumvent any unanimous consent requirement. Instead, its purpose is usually to use the coercive power of the exit consent to increase the chances of the exchange offer being accepted. The bond issuer will adopt the exit consent technique only if there is no definitive majority. Had there been a definitive majority group, they would be able to collaborate and choose to reject the exchange offer if they perceive that the exchange offer does not reflect the true value of the bonds.

contractual implied terms.[69] Accordingly, contracting parties are free to modify an equitable doctrine or even contract it out altogether. In commercial settings where all parties are of sound mind and competent, the application of equitable rules and principles should be subject to the parties' intent, ascertained through the contractual terms and other relevant circumstances. In *Hospital Products Ltd v United States Surgical Corporation*,[70] Mason J made an instructive observation about the supremacy of contract over equity in the context of fiduciary relationships:

> "That contractual and fiduciary relationships may co-exist between the same parties has never been doubted. Indeed, the existence of a basic contractual relationship has in many situations provided a foundation for the erection of a fiduciary relationship. In these situations it is the contractual foundation which is all important because it is the contract that regulates the basic rights and liabilities of the parties. The fiduciary relationship, if it is to exist at all, must accommodate itself to the terms of the contract so that it is consistent with, and conforms to, them. The fiduciary relationship cannot be superimposed upon the contract in such a way as to alter the operation which the contract was intended to have according to its true construction".[71]

In *Assenagon*, each bondholder had the choice to *become a member of the majority*. Therefore, it is possible to argue that the parties' presumed intent was that each bondholder was entitled to prioritise its own interest over the interest of those bondholders who chose not to be in the majority group. A strict application of the abuse principle would mean that each bondholder must vote against the resolution and reject the exchange offer, even if it honestly believes that the exchange offer reflects the true value of the existing bonds, and is better than

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69 Anthony J Duggan "Is Equity Efficient?" [1997] 113LQR 601 at 624. See also *Redwood Masterfund Ltd v TD Bank Europe Ltd* [2002] EWHC 2703 (Ch) at [92] where the judge said that the basis of the abuse principle was an implied contractual term.

70 (1984) 156 CLR 41.

71 At 97.

other alternatives – being the issuer's bankruptcy or a mandatory reduction of the amounts of the bonds by the government through legislation. This is unlikely to be the parties' intention.

Thirdly, even assuming that the abuse principle does apply in exit consent cases like *Assenagon*, an argument can be made that the consenting bondholders did not breach the abuse principle. As in most debt restructuring situations, each bondholder in *Assenagon* was confronted by two difficult choices: a "yes" vote would increase the likelihood of the restructuring proposal being passed, resulting in most (and potentially all) of the bondholders exchanging exiting bonds with new bonds with a 80% haircut; a "no" vote would increase the chances of the restructuring proposal being rejected, resulting in the Irish government exercising its legal power to restructure the bonds. Given the Irish government's threat and the extremely precarious global financial markets at the time, it is at least arguable that voting for the resolution is actually *in the best interest of the bondholders as a whole*.

It may be added that, from a practical perspective, it is questionable whether a collateral duty imposed on bondholders is realistic in modern capital markets. Given the constant flux of bondholders as a result of active trading, and the fact that sometimes a bondholder may be expressly or implicitly required to vote in accordance with the direction of a third party,[72] the issuer-bondholder relationship should be the only source of duties.[73] This would obviate the need to inquire into the motives for the exercise of each individual bondholder's voting right.

One aspect of *Assenagon*, which was not fully explored in the judgment, is the role played by the issuer. Briggs J seemed to view this issue as not important, because "the coercive power of the exit consent is one which can only be wielded by the majority of the very class which the

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72 This may happen in cases where a bondholder has purchased credit protection from the third party, and is contractually required to exercise its voting right in accordance with the instructions of the protection seller.

73 Keegan S Drake "The Fall and Rise of the Exit Consent" (2014) 63 Duke LJ 1589 at 1622–1623.

issuer wishes to coerce, and not by the issuer itself."[74] However, it is obvious that it is the bond issuer, not the bondholders, who made the exchange offer coupled with an exit consent. This leads to the question of whether the issuer is in breach of its duties when using the exit consent technique, which is discussed below.

7.4. Duty of the bond issuer

The third legal theory that might be used to attack the legality of exit consents is based on a breach of duty *by the issuer*. This theory was relied by the plaintiff in a Delaware case, *Katz v Oak Industries Inc*.[75] In this case, the bond issuer experienced a series of losses from its operations. As part of its restructuring and recapitalisation plan, the issuer offered to exchange its bonds for shares or a payment certificate payable in cash at a price less than the face value of the bonds. The exchange offer was coupled with an exit consent for removing all financial covenants in the indenture. One bondholder sought an injunction from the court, alleging that the linking of the exchange offer and the exit consent constituted a breach of the good faith obligation that the issuer owed to its bondholders.[76] The court held that the appropriate legal test was whether it was clear from the express terms of the indenture that the parties would have agreed to proscribe the act later complained as a breach of the implied duty of good faith.[77] After reviewing the relevant terms of the indenture, the court concluded that the plaintiff failed to demonstrate a probability of ultimate success, and denied the injunction application accordingly.

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74 *Assenagon*, above n 13, at [76].

75 508 A2d 873 (Del Ch 1986).

76 Under the US law, a general duty of good faith and fair dealing is implied in all contracts. See §205 of the U.S. Restatement (Second) of the Law of Contracts (1979).

77 *Katz*, above n 75, at 880.

The breach of the issuer's duty argument has not been tested in the context of exit consent in an English court, but it was adopted by the claimants in *Azevedo*, a case of consent payments.

7.4.1 *Azevedo*

In 2006, the Imcopa Group of companies (Imcopa) issued US$100 million bonds as part of its refinancing efforts. In 2010, Imcopa sent all bondholders a proposal seeking a bondholder resolution for postponement of an interest payment and other amendments. Under the proposal, a consent payment would be made to those bondholders who voted in favour of the resolution. The proposal was passed by an overwhelming majority. Two of the dissenting bondholders issued proceedings, claiming that the resolution was void because the consent payments were in the nature of a bribe.[78] Specifically, the claimants alleged that the issuer gave the consenting bondholders "special personal advantage" in order to induce them to assent.[79] In the High Court, Hamblen J rejected this claim.[80] After the claimant's appeal, Lloyd LJ delivered the judgment of the Court of Appeal.

Lloyd LJ held that consent payments were not inconsistent with English company law, because all the details of the scheme were fully disclosed to all bondholders, and the same benefit was available to all members of the class.[81] There was no "pre-ordained discrimination between a majority and a minority".[82] In contrast, in cases such as *Menier v Hooper's*

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78 The other argument raised by the claimants was that the consent payments breached the *pari passu* provisions in the bond terms. This argument was rejected by the court.

79 In this case, the claimant did not allege minority oppression, because the resolution, on its own merits, was beneficial to the bondholders as a whole.

80 *Azevedo v IMCOPA – Importacao, Exportaacao e Industria de Oleos Ltda* [2012] EWHC 1849 (Comm).

81 *Azevedo*, above n 14, at [63].

82 *Azevedo*, above n 14, at [71].

Telegraph Works[83] and *British America Nickel Corpn Ltd v MJ O'Brien Ltd*,[84] the relevant schemes were held to be unlawful because the benefit offered to a specific member of the group was not available to other members.

7.4.2 Exit consent under English company law

While *Azevedo* affirms the general understanding of the market that consent payments are generally lawful, whether an exit consent may violate the issuer's duty under English company law has not been tested in court.[85] As a number of commentators have pointed out, the differences between exit consents and consent payments are in their form, not in substance.[86] A consent payment constitutes a positive inducement, whilst an exit consent is a negative one. Both methods have a coercive effect: a dissenting bondholder will not receive the consent fee (in the case of a consent payment) or be left with the previous bonds with unfavourable terms (in the case of an exit consent). Given that a consent payment does not constitute a breach of duty by the issuer, by analogy, an exit consent should not be a breach either.

On a policy level, a prohibition on the issuer using the exit consent technique would be inconsistent with the commercial nature of the relationship between the issuer and its bondholders. In addition, in terms of English law governed bonds, the two possible reasons for an issuer to use an exit consent are to ensure that the quorum requirement is met, or to increase the likelihood of the proposed resolution being passed. Studies show that an inability of

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83 (1874) LR 9 Ch App 350. In this case, the directors of a company decided not to pursue its claims in a litigation, with the result that its majority shareholder was able to achieve an advantage. It was held that the majority expropriated the minority.

84 [1927] AC 369.

85 Although both parties' submissions contained references to *Assenagon*, Lloyd LJ stated that *Assenagon* was of no assistance as the facts of the two cases were too far away.

86 See for example Smith and Sharpe, above n **Error! Bookmark not defined.**, at 289–290.

bondholders to coordinate their responses is exaggerated.[87] As such, it is possible that the issuer's main purpose of adopting the exit consent is simply to coerce inactive bondholders into voting. In any event, when a distressed issuer is fighting for its survival, adopting a coercive technique but in a clear and transparent manner is hardly something a dissenting bondholder can complain about.

7.5 Conclusion

Modern bond markets are built upon layers and layers of carefully drafted complex documentation, most of which are now standardised. There is a shared understanding among market participants as to each party's rights and obligations under standard documentation. When an investor chooses to invest in bonds, the presumption should be that the investor agrees to accept the bond terms in the same way as commonly understood in the market, particularly the understanding shared by leading law firms who, on behalf of their clients, prepared or reviewed the contract. Therefore, it can be argued that the common view of the market deserves more weight than it is currently given by the courts. Of course, this is not to say that a court may never deviate from the market's common view. Nevertheless, such deviation must be supported by an in-depth understanding of bond markets practice, a proper legal reasoning and careful policy considerations.[88]

The decisions of the US District Court in *Marblegate* and *Caesars* and the UK High Court decision in *Assenagon* represent a significant departure from the prevailing view of the market participants. Their impact is chilling: they have encouraged holdout investors to bring more

87 Kahan and Tuckman, above n 7; Robert Peel "Assessing the Legality of Coercive Restructuring Tactics in UK Exchange Offers' (2015) 4 UCL JL and J 162 at 187.

88 In general, the US courts tend to openly consider policy factors, whereas UK judges prefer a traditional doctrinal approach. See Edward B Rock "Corporate Law Doctrine and the Legacy of American Legal Realism" (2015) 163 U Pa L Rev 2019.

actions in court,[89] resulted in greater uncertainty among legal practitioners,[90] and left fewer options for out-of-court debt restructurings.[91]

The overturn of the US District Court decision in *Marblegate* by the US Court of Appeal brings much-needed certainty to the US restructuring market, and restores confidence in the common understanding of law shared by restructuring practitioners. Unfortunately, the legal position of exit consent under English law remains unclear.

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89 See for example *Barkau v California Resources Corp*. No. 16–cv–02971 (S.D.N.Y. 2016); *Cummings v Chesapeake Energy Corp*. No. 16–cv–02338 (SD NY 2016).

90 Because of the district court decisions in *Marblegate* and *Caesars*, 28 prominent US law firms issued an Opinion White Paper to provide guidance to practitioners.

91 To the best knowledge of the author, the exit consent technique has not been used in the New Zealand market. Until *Assenagon* is overruled, it seems unlikely that this technique will be used in New Zealand any time soon.

CHAPTER 8 CONCLUSIONS

> [W]ise judges have often warned against the wholesale importation into commercial law of equitable principles inconsistent with the certainty and speed which are essential requirements for the orderly conduct of business affairs.[1]

Over the years, different legal regimes of bond trusts have evolved in common law and civil law jurisdictions. In the US, most bond trusts are regulated under a statutory framework – the TIA. While most of the mandatory provisions regarding the bond trustee's duties and liabilities are largely consistent with the English law position, one particular section – s 316(b) – has given rise to many controversies and debates.

Section 316(b) provides that each bondholder's payment rights under the indenture shall not be impaired without its consent. Originally, the purpose of this section was to combat the situation where the majority bondholders colluded with the issuer to harm the minority holders' interest. In recent years, however, hedge fund investors have exploited this section in bond restructurings.[2] While the Second Circuit's decision in the *Marblegate* case has provided much-needed clarity for the operation of s 316(b) in respect of exit consents in corporate bond restructurings, the issues with sovereign debts remain. In recent years, various international organisations have taken initiatives to promote the adoption of collective action clauses in sovereign bond offerings.

Other that s 316(b), the bond trust regulatory regime under the TIA is relatively similar to that under English law. An important common feature of both regimes is the lack of the bond trustee's duties to monitor the performance of the issuer, or to identify any potential or actual default. Some commentators have proposed that proper protection of bondholders requires such

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1 *Westdeutsche Landesbank Girozentrale v Islington London Borough Council* [1996] 2 AC 669 (HL) at 704, per Lord Browne-Wilkinson.

2 Sovereign bonds issued under the US law, while technically not governed by the TIA, tend to contain provisions similar to s 316(b).

duties be imposed on the bond trustee. In this regard, it might be useful to draw some lessons from the bond trust regulation under Australian and New Zealand laws.[3]

A monitoring duty of bond trustees has long existed within Australian and New Zealand laws. Yet, the large-scale failures of finance companies and substantial losses suffered by bond investors in recent years suggest that this approach has failed to achieve its intended purposes. In fact, it is difficult for the bond trustee, an external commercial entity not closely involved in the day-to-day operations of the issuer, to conduct effective monitoring of the issuer's performance. On the other hand, however, the relatively strong retail participation in the New Zealand bond markets does require a strong regulatory regime to protect the investing public.[4] This thesis has proposed that, compared to trust corporations, the Financial Markets Authority (NZ) is better positioned to take on the role of monitoring the performance of bond issuers.

One interesting legislative change brought about by the Financial Markets Conduct Act 2013 (NZ) is the replacement of the term "trustee" by "supervisor". This is because of the concern that the term "trustee" might give a false impression to investors that their funds are placed under a traditional trust structure. Indeed, while a bond trust does meet the three certainty requirements for creating an express private trust,[5] a court, analysing legal issues of a bond

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3 Under the Australia/New Zealand laws, the monitoring duty is mandatory only in respect of retail bonds. In contrast, the majority of bond investors in the London/New York markets are mostly institutional investors. However, the insights offered and lessons learned from the study of the bond trust regime under the Australia/New Zealand law will still be valuable, as the size of retail bond markets in the US and the UK is growing. See Rohini Tendulkar and Gigi Hancock "Corporate Bond Markets: A Global Perspective" (OICV–IOSCO SWP4/2014, February 2014) <www.iosco.org> at 48; Helen Power "The Rise of the Retail Bond" (1 July 2014) London Stock Exchange Group <www.lseg.com>.

4 Another reason for the necessity of a bond trustee is the lack of a well-established secondary bond market. See Mark Blair and Ian Ramsay "Collective Investment Schemed: The Role of the Trustee" (1992) 1(3) Australian Accounting Review 10 at 13.

5 Ravi C Tennekoon *The Law and Regulation of International Finance* (Butterworths, London, 1991) at 225–228.

trust structure under a general trust law framework, may find itself in a dilemma where the terms of a bond trust reduce or limit the core duties of a trustee. If the court upholds the validity of such terms, it would contradict the long-held trust law principle that the trustee's obligations cannot be reduced below the irreducible minimum identified in *Armitage v Nurse*;[6] if the court holds such terms invalid, it would upset commercial deals.

This thesis has argued that bond trusts are more similar to multilateral contracts as opposed to traditional express trusts. This is because of the fundamental differences between a bond trust and a traditional trust. Unlike a traditional trust, the trust property of a bond trust does not have an independent economic value. As a result, the beneficiaries of a bond trust do not enjoy the same protection against the settlor or the trustee as is so in traditional trusts.

Modern bond markets are built upon layers and layers of carefully drafted complex documentation. The need for certainty and predictability is more imperative than ever. Many contract terms are now standardized and possess a consensus on the interpretation of those terms. When two commercial parties have willingly entered into a contract with the standard terms, the presumption is that they intend to be bound by those terms *in accordance with the meaning as understood by market participants in general*.[7] As such, a strong policy argument can be made that, as a general rule, the courts' interpretation of those standard terms should accord with market perceptions. Court decisions, which are contrary to long-held market consensus, may inflict serious damage to the proper operation of financial markets. The recent "flip clause" cases provide a perfect example in this regard.

Under the terms of a structured note, the issuer enters into a swap transaction under which the issuer pays to the swap counterparty the return of the underlying assets held by the issuer,

6 [1997] Ch 241.

7 See for example Agasha Mugasha "International Financial Law: Is the Law Really 'International' and Is It 'Law' Anyway?" (2011) 26 BFLR 381 at 427.

and receives fixed or floating rate payments from the swap counterparty. The issuer pays the fixed or floating payments to the noteholders in accordance with the terms of the structured note. If the issuer defaults, the underlying assets will be sold and the proceeds will be paid to the swap counterparty first to satisfy any amount owed by the issuer to the swap counterparty, and then to the noteholders. However, if the swap counterparty defaults, the priority of termination payments will be reversed: in which case, the noteholders will be paid ahead of the swap counterparty (the flip clause).

In 2010, Judge Peck of the US Bankruptcy Court held that the flip clause was unlawful as it was in breach of US bankruptcy law.[8] This decision directly contradicted the market consensus of the time, sending shockwaves to structured financial markets around the globe.[9] It is thus comforting to note that, in a recent decision, the US Bankruptcy Court departed from Judge Peck's decision and upheld the enforceability of flip clauses.[10] This decision was widely welcomed as it reassured structured financial markets of the sanctity of contracts.[11]

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8 *Lehman Brothers Special Financing Inc v BNY Corporate Trustee Services Ltd* 422 BR 407 (Bankr SD NY 2010). In contrast, the validity of flip clauses was confirmed by all three levels of English courts. *Perpetual Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWHC 1912 (Ch); *Trustee Company Ltd v BNY Corporate Trustee Services Ltd* [2009] EWCA Civ 1160; *Belmont Park Investments Pty Ltd v BNY Corporate Trustee Services Ltd* [2011] UKSC 38.

9 See for example Pierre J Riou "The Flap over Flip Clauses" (2012) 31 Am Bankr Inst J 34. It was estimated that, because of Judge Peck's ruling, Lehman (the swap counterparty) was able to recoup hundreds of millions of dollar through settlements. Karen O'Flynn and Flora Innes "The Courts Flip-flopping (Again) on the Validity of 'Flip Clauses'" (01 September 2016) Clayton Utz <www.claytonutz.com>.

10 *Lehman Brothers Special Financing Inc v Bank of America National Association* 553 BR 476 (Bankr SD NY 2016).

11 See for example Michael J Venditto, David M Schlecker and Sarah K Kam "A Flip on the Flip Clause: Lehman Court Changes Course on Flip Provisions and Financial Safe Harbors" (6 July 2016) Reed Smith <www.reedsmith.www>; Karen O'Flynn and Flora Innes "The Courts Flip-flopping (Again) on the Validity of 'Flip Clauses'" (01 September 2016) Clayton Utz <www.claytonutz.com>.

Almost a hundred years ago, Posner observed that "[t]he trustee under the corporate indenture has become an essential and characteristic institution in modern finance. The annual investment of hundreds of millions of dollars in securities issued under such indenture is proof of the necessity no less than of the popularity of the device".[12] Without a doubt, these words are as fitting today as then, the only caveat being the word "millions" has to be replaced with "billions", if not "trillions".

Indeed, the sheer size of bond markets and the fast-paced development of new products demands more research in the function of corporate trustees. One area for future research is peer-to-peer lending.[13] Some peer-to-peer lending platforms have adopted a trust structure under which a trust company is appointed as trustee acting for the benefit of the lenders if the lending platform defaults.

Another area for potential future research is bond trust law in China. China is poised to be one of the biggest corporate bond markets. The robustness and effectiveness of the bond trustee's role in the Chinese law context will be put to the test if wide-scale issuer defaults occur. A detailed comparative study of the Chinese bond trust law against the UK/US bond trust laws will offer valuable insights to the PRC regulators, policymakers, and the local trust corporations.

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12 Louis S Posner "Liability of the Trustee under the Corporate Indenture" (1928) 42 Harv L Rev 198.

13 Peer-to-peer lending refers to a type of financing conducted through an online platform.

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